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Uniform CPA examination, May 1985-May 1989. Selected questions and unofficial answers indexed to content specification outline; Selected questions and unofficial answers

James D. Blum

American Institute of Certified Public Accountants. Board of Examiners

American Institute of Certified Public Accountants. Examinations Division

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Also Includes
Complete Text of
November 1989
Uniform CPA Examination
Questions & Unofficial Answers

**Uniform CPA Examination
May 1985-May 1989**

**Selected
Questions
& Unofficial
Answers**

**Indexed To
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**Accounting Practice
Accounting Theory
Auditing
Business Law**

AICPA

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Edited by the Staff of the Examinations Division:

James D. Blum
Director

Aubrey Kosson
Senior
Technical Manager

Bruce H. Biskin
Senior
Psychometrician

Technical Managers:

Edward R. Gehl
Joel Koppelman
Lawrence Lindenberg
Alan F. Smith

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FOREWORD

The Uniform CPA Examination is prepared by the Board of Examiners of the American Institute of Certified Public Accountants, and is used by the examining boards of all fifty states of the United States, the District of Columbia, Puerto Rico, Guam, and the Virgin Islands, as a prerequisite for issuance of CPA certificates.

This book contains selected questions and unofficial answers from the nine Uniform Certified Public Accountant Examinations from May 1989 back to May 1985. The questions and unofficial answers have been indexed in accordance with the Content Specification Outlines for the Uniform Certified Public Accountant Examination.

All questions are identified by a boldface code indicating the month—May (M) or November (N)—the year (85 through 89), and the question number in the original examination. Within the content specification areas and groups, questions and answers have been arranged in reverse chronological order.

Each individual multiple choice question is indexed according to the area and group it tests. In some cases, a common fact pattern is used for two or more multiple choice questions. In such cases, where different areas and groups are being tested by questions referring to a common fact pattern, the fact pattern is repeated to accompany the questions indexed in each applicable area or group.

Each essay question is indexed according to the area it tests and in certain cases to the group it tests. Where essay questions and their answers involve more than one part—for example, part a. and part b.—the essays have been separated and indexed according to areas and groups tested. Thus, all parts of a question and its answer may not appear in their original examination sequence.

In addition to the selected questions and unofficial answers, all of the questions and unofficial answers from the November 1989 Uniform CPA Examination are included at the end of the book. Following the November 1989 exam's questions and unofficial answers is an index of the exam's questions which classifies them in accordance with each section's Content Specification Outline.

Although the questions and unofficial answers may be used for many purposes, the principal reason for their publication is to aid candidates in preparing to take the examination. Candidates are also encouraged to read *Information for CPA Candidates*, which describes the content, grading, and other administrative aspects of the Uniform CPA Examination.







The unofficial answers were prepared by the staff of the Examinations Division and reviewed by the Board of Examiners but are not purported to be official positions of the American Institute of Certified Public Accountants.

Rick Elam, *Vice President—Education*
American Institute of Certified Public Accountants

January 1990

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Accounting Practice



**Selected Questions
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MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. Presentation of Financial Statements or Worksheets

A. Balance Sheet

1M89#1. Rogo Corp.'s trial balance reflected the following account balances at December 31, 1988:

Accounts receivable (net)	\$16,000
Short-term investments	5,000
Accumulated depreciation on equipment and furniture	15,000
Cash	11,000
Inventory of merchandise	30,000
Equipment and furniture	25,000
Patent	4,000
Prepaid expenses	1,000
Land held for future business site	18,000

In Rogo Corp.'s December 31, 1988 balance sheet, the current assets total is

- a. \$81,000
- b. \$73,000
- c. \$67,000
- d. \$63,000

1M89

Items 2 through 4 are based on the following:

The following trial balance of Shaw Corp. at December 31, 1988 has been adjusted except for income tax expense.

Shaw Corp.
TRIAL BALANCE
December 31, 1988

	<u>Dr.</u>	<u>Cr.</u>
Cash	\$ 675,000	
Accounts receivable (net)	2,695,000	
Inventory	2,185,000	
Property, plant and equipment (net)	7,366,000	
Accounts payable and accrued liabilities		\$ 1,801,000
Income tax payable		654,000
Deferred income tax liability		85,000
Common stock		2,300,000

	<u>Dr.</u>	<u>Cr.</u>
Additional paid-in capital		3,680,000
Retained earnings, 1/1/88		3,350,000
Net sales and other revenues		13,360,000
Costs and expenses	11,180,000	
Income tax expense	1,129,000	
	<u>\$25,230,000</u>	<u>\$ 25,230,000</u>

Other financial data for the year ended December 31, 1988:

Included in accounts receivable is \$1,000,000 due from a customer and payable in quarterly installments of \$125,000. The last payment is due December 30, 1990.

The balance in the deferred income tax liability account pertains to a temporary difference that arose in a prior year, of which \$15,000 is expected to be paid in 1989. Shaw elected to apply the provisions of FASB Statement No. 96, *Accounting for Income Taxes*, in its financial statements for the year ended December 31, 1988.

During the year, estimated tax payments of \$475,000 were charged to income tax expense. The current and future tax rate on all types of income is 30%.

In Shaw's December 31, 1988 balance sheet,

2. The current assets total is
 - a. \$6,030,000
 - b. \$5,555,000
 - c. \$5,530,000
 - d. \$5,055,000
3. The current liabilities total is
 - a. \$1,995,000
 - b. \$2,065,000
 - c. \$2,470,000
 - d. \$2,540,000
4. The final retained earnings balance is
 - a. \$4,401,000
 - b. \$4,486,000
 - c. \$4,876,000
 - d. \$5,055,000

Accounting Practice

B. Income Statement

1N88

Items 7 through 9 are based on the following:

Karl Corp.'s trial balance of income statement accounts for the year ended December 31, 1987 included the following:

	<u>Debit</u>	<u>Credit</u>
Sales		\$150,000
Cost of sales	\$ 60,000	
Administrative expenses	15,000	
Loss on sale of equipment	9,000	
Commissions to salespersons	10,000	
Interest revenue		5,000
Freight out	3,000	
Loss on early retirement of long-term debt	10,000	
Bad debt expense	3,000	
Totals	<u>\$110,000</u>	<u>\$155,000</u>

Other information

Finished goods inventory:	
January 1, 1987	\$100,000
December 31, 1987	\$ 90,000

Karl's income tax rate is 30%.

On Karl's multiple-step income statement for 1987,

7. Cost of goods manufactured is
 - a. \$73,000
 - b. \$70,000
 - c. \$53,000
 - d. \$50,000
8. Income before extraordinary item is
 - a. \$55,000
 - b. \$45,000
 - c. \$38,500
 - d. \$31,500
9. Extraordinary loss is
 - a. \$ 7,000
 - b. \$10,000
 - c. \$13,300
 - d. \$19,000

C. Statement of Cash Flows

1M89

Items 5 through 7 are based on the following:

Dice Corp.'s balance sheet accounts as of December 31, 1988 and 1987 and information relating to 1988 activities are presented below.

	<u>December 31,</u>	
	<u>1988</u>	<u>1987</u>
<u>Assets</u>		
Cash	\$ 230,000	\$ 100,000
Short-term investments	300,000	—
Accounts receivable (net)	510,000	510,000
Inventory	680,000	600,000
Long-term investments	200,000	300,000
Plant assets	1,700,000	1,000,000
Accumulated depreciation	(450,000)	(450,000)
Goodwill	90,000	100,000
Total assets	<u>\$3,260,000</u>	<u>\$2,160,000</u>
<u>Liabilities and Stockholders' Equity</u>		
Accounts payable and accrued liabilities	\$ 825,000	\$ 720,000
Short-term debt	325,000	—
Common stock \$10 par	800,000	700,000
Additional paid-in capital	370,000	250,000
Retained earnings	940,000	490,000
Total liabilities and stockholders' equity	<u>\$3,260,000</u>	<u>\$2,160,000</u>

Information relating to 1988 activities

- Net income for 1988 was \$690,000.
 - Cash dividends of \$240,000 were declared and paid in 1988.
 - Equipment costing \$400,000 and having a carrying amount of \$150,000 was sold in 1988 for \$150,000.
 - A long-term investment was sold in 1988 for \$135,000. There were no other transactions affecting long-term investments in 1988.
 - 10,000 shares of common stock were issued in 1988 for \$22 a share.
 - Short-term investments consist of treasury bills maturing on 6/30/89.
5. Net cash provided by Dice's 1988 operating activities was
 - a. \$690,000
 - b. \$915,000
 - c. \$940,000
 - d. \$950,000
 6. Net cash used in Dice's 1988 investing activities was
 - a. \$1,115,000
 - b. \$ 895,000
 - c. \$ 865,000
 - d. \$ 815,000
 7. Net cash provided by Dice's 1988 financing activities was
 - a. \$305,000
 - b. \$440,000
 - c. \$455,000
 - d. \$545,000

Selected Questions

1M89

Items 9 and 10 are based on the following:

Brock Corp.'s transactions for the year ended December 31, 1988 included the following:

- Acquired 50% of Hoag Corp.'s common stock for \$225,000 cash which was borrowed from a bank.
- Issued 5,000 shares of its preferred stock for land having a fair value of \$400,000.
- Issued 500 of its 11% debenture bonds, due 1996, for \$490,000 cash.
- Purchased a patent for \$275,000 cash.
- Paid \$150,000 toward a bank loan.
- Sold investment securities for \$995,000.
- Had a net increase in customer deposits of \$110,000.

9. Brock's net cash provided by investing activities for 1988 was

- a. \$370,000
- b. \$495,000
- c. \$595,000
- d. \$770,000

10. Brock's net cash provided by financing activities for 1988 was

- a. \$565,000
- b. \$675,000
- c. \$715,000
- d. \$825,000

1M89

Items 16 and 17 are based on the following:

Kollar Corp.'s transactions for the year ended December 31, 1988 included the following:

- Purchased real estate for \$550,000 cash which was borrowed from a bank.
- Sold investment securities for \$500,000.
- Paid dividends of \$600,000.
- Issued 500 shares of common stock for \$250,000.
- Purchased machinery and equipment for \$125,000 cash.
- Paid \$450,000 toward a bank loan.
- Reduced accounts receivable by \$100,000.
- Increased accounts payable, by \$200,000.

16. Kollar's net cash used in investing activities for 1988 was

- a. \$675,000
- b. \$375,000
- c. \$175,000
- d. \$ 50,000

17. Kollar's net cash used in financing activities for 1988 was

- a. \$ 50,000
- b. \$250,000
- c. \$450,000
- d. \$500,000

D. Statement of Owners' Equity

1M89#13. Effective April 27, 1988, the stockholders of Dorr Corp. approved a 2-for-1 split of the company's common stock, and an increase in authorized common shares from 100,000 shares (par value \$20 per share) to 200,000 shares (par value \$10 per share). Dorr's stockholders' equity accounts immediately before issuance of the stock split shares were as follows:

Common stock, par value \$20;	
100,000 shares authorized;	
50,000 shares outstanding	\$1,000,000
Additional paid-in capital (\$3 per	
share on issuance of common stock)	150,000
Retained earnings	1,350,000

The stock split shares were issued on June 30, 1988. In Dorr's June 30, 1988 statement of stockholders' equity, the balances of additional paid-in capital and retained earnings are

	<u>Additional paid-in capital</u>	<u>Retained earnings</u>
a.	\$0	\$ 500,000
b.	\$ 150,000	\$ 350,000
c.	\$ 150,000	\$1,350,000
d.	\$1,150,000	\$ 350,000

1M89#14. On February 1, 1988, Kew Corp., a newly formed company, had the following stock issued and outstanding:

- Common stock, no par, \$1 stated value, 10,000 shares originally issued for \$15 per share.
- Preferred stock, \$10 par value, 3,000 shares originally issued for \$25 per share.

Kew's February 1, 1988 statement of stockholders' equity should report

	<u>Common stock</u>	<u>Preferred stock</u>	<u>Additional paid-in capital</u>
a.	\$150,000	\$30,000	\$ 45,000
b.	\$150,000	\$75,000	\$0
c.	\$ 10,000	\$75,000	\$140,000
d.	\$ 10,000	\$30,000	\$185,000

1M89#18. Munn Corp.'s records included the following stockholders' equity accounts:

Preferred stock, par value \$15, authorized	
20,000 shares	\$255,000
Additional paid-in capital, preferred stock	15,000
Common stock, no par, \$5 stated value,	
100,000 shares authorized	300,000

Accounting Practice

In Munn's statement of stockholders' equity, the number of issued and outstanding shares for each class of stock is

	<u>Common stock</u>	<u>Preferred stock</u>
a.	60,000	17,000
b.	60,000	18,000
c.	63,000	17,000
d.	63,000	18,000

E. Consolidated Financial Statements or Worksheets

1M89

Items 55 and 56 are based on the following:

On January 1, 1988, Ritt Corp. purchased 80% of Shaw Corp.'s \$10 par common stock for \$975,000. On this date, the carrying amount of Shaw's net assets was \$1,000,000. The fair values of Shaw's identifiable assets and liabilities were the same as their carrying amounts except for plant assets (net) which were \$100,000 in excess of the carrying amount. For the year ended December 31, 1988, Shaw had net income of \$190,000 and paid cash dividends totaling \$125,000.

55. In the January 1, 1988 consolidated balance sheet, goodwill should be reported at

- a. \$0
- b. \$ 75,000
- c. \$ 95,000
- d. \$175,000

56. In the December 31, 1988 consolidated balance sheet, minority interest should be reported at

- a. \$200,000
- b. \$213,000
- c. \$220,000
- d. \$233,000

1M89

Items 57 and 58 are based on the following:

On June 30, 1988, Purl Corp. issued 150,000 shares of its \$20 par common stock for which it received all of Scott Corp.'s common stock. The fair value of the common stock issued is equal to the book value of Scott Corp.'s net assets. Both corporations continued to operate as separate businesses, maintaining accounting records with years ending December 31. Net income from separate company operations and dividends paid were:

	<u>Purl</u>	<u>Scott</u>
<u>Net income</u>		
Six months ended 6/30/88	\$750,000	\$225,000
Six months ended 12/31/88	825,000	375,000
<u>Dividends paid</u>		
March 25, 1988	950,000	—
November 15, 1988	—	300,000

On December 31, 1988, Scott held in its inventory merchandise acquired from Purl on December 1, 1988 for \$150,000, which included a \$45,000 markup.

57. Assume that the business combination qualifies for treatment as a purchase. In the 1988 consolidated income statement, net income should be reported at

- a. \$1,650,000
- b. \$1,905,000
- c. \$1,950,000
- d. \$2,130,000

58. Assume that the business combination qualifies for treatment as a pooling of interests. In the 1988 consolidated income statement, net income should be reported at

- a. \$1,905,000
- b. \$1,950,000
- c. \$2,130,000
- d. \$2,175,000

1N88

Items 2 through 6 are based on the following:

On January 1, 1988, Polk Corp. and Strass Corp. had condensed balance sheets as follows:

	<u>Polk</u>	<u>Strass</u>
Current assets	\$ 70,000	\$20,000
Noncurrent assets	90,000	40,000
Total assets	<u>\$160,000</u>	<u>\$60,000</u>
Current liabilities	\$ 30,000	\$10,000
Long-term debt	50,000	—
Stockholders' equity	80,000	50,000
Total liabilities and stockholders' equity	<u>\$160,000</u>	<u>\$60,000</u>

On January 2, 1988, Polk borrowed \$60,000 and used the proceeds to purchase 90% of the outstanding common shares of Strass. This debt is payable in 10 equal annual principal payments, plus interest, beginning December 30, 1988. The excess cost of the investment over Strass' book value of acquired net assets should be allocated 60% to inventory and 40% to goodwill.

On Polk's January 2, 1988 consolidated balance sheet,

2. Current assets should be
 - a. \$99,000
 - b. \$96,000
 - c. \$90,000
 - d. \$79,000
3. Noncurrent assets should be
 - a. \$130,000
 - b. \$134,000
 - c. \$136,000
 - d. \$140,000

Selected Questions

4. Current liabilities should be

- \$50,000
- \$46,000
- \$40,000
- \$30,000

5. Noncurrent liabilities including minority interests should be

- \$115,000
- \$109,000
- \$104,000
- \$ 55,000

6. Stockholders' equity should be

- \$ 80,000
- \$ 85,000
- \$ 90,000
- \$130,000

1M88#10. King Corp. owns 80% of Lee Corp.'s common stock. During October 1987, Lee sold merchandise to King for \$100,000. At December 31, 1987, one-half of the merchandise remained in King's inventory. For 1987, gross profit percentages were 30% for King and 40% for Lee. The amount of unrealized intercompany profit in ending inventory at December 31, 1987 that should be eliminated in consolidation is

- \$40,000
- \$20,000
- \$16,000
- \$15,000

1M88#11. Dunn Corp. owns 100% of Grey Corp.'s common stock. On January 2, 1986, Dunn sold to Grey for \$40,000 machinery with a carrying amount of \$30,000. Grey is depreciating the acquired machinery over a five-year life by the straight-line method. The net adjustments to compute 1986 and 1987 consolidated income before income tax would be an increase (decrease) of

	1986	1987
a.	(\$ 8,000)	\$2,000
b.	(\$ 8,000)	\$0
c.	(\$10,000)	\$2,000
d.	(\$10,000)	\$0

1M88

Items 13 through 17 are based on the following information:

On June 30, 1987, Post, Inc. issued 630,000 shares of its \$5 par common stock, for which it received 180,000 shares (90%) of Shaw Corp.'s \$10 par common stock, in a business combination appropriately accounted for as a pooling of interests. The stockholders' equities immediately before the combination were:

	Post	Shaw
Common stock	\$ 6,500,000	\$2,000,000
Additional paid-in capital	4,400,000	1,600,000
Retained earnings	6,100,000	5,400,000
	<u>\$17,000,000</u>	<u>\$9,000,000</u>

Both corporations continued to operate as separate businesses, maintaining accounting records with years ending December 31. For 1987, net income and dividends paid from separate company operations were:

	Post	Shaw
<u>Net income</u>		
Six months ended 6/30/87	\$1,000,000	\$300,000
Six months ended 12/31/87	1,100,000	500,000

Dividends paid

April 1, 1987	1,300,000	—
October 1, 1987	—	350,000

13. In the June 30, 1987 consolidated balance sheet, common stock should be reported at

- \$9,650,000
- \$9,450,000
- \$8,500,000
- \$8,300,000

14. In the June 30, 1987 consolidated balance sheet, additional paid-in capital should be reported at

- \$4,400,000
- \$4,490,000
- \$5,840,000
- \$6,000,000

15. In the June 30, 1987 consolidated balance sheet, retained earnings should be reported at

- \$ 6,100,000
- \$ 9,660,000
- \$10,960,000
- \$11,500,000

16. In the 1987 consolidated income statement, net income should be reported at

- \$2,550,000
- \$2,600,000
- \$2,820,000
- \$2,900,000

17. In the December 31, 1987 consolidated balance sheet, total minority interest should be reported at

- \$950,000
- \$945,000
- \$915,000
- \$900,000

Accounting Practice

2M87

Items 4 through 11* are based on the following data:

The separate condensed balance sheets and income statements of Par Corp. and its wholly-owned subsidiary, Sub Corp., are as follows:

BALANCE SHEETS December 31, 1986

	<u>Par</u>	<u>Sub</u>
<u>Assets</u>		
Current		
Cash	\$ 150,000	\$ 50,000
Accounts receivable (net)	190,000	60,000
Inventories	90,000	40,000
Total current assets	430,000	150,000
Property, plant, and equipment (net)	365,000	200,000
Investment in Sub (equity method)	315,000	—
Total assets	<u>\$1,110,000</u>	<u>\$350,000</u>

Liabilities and Stockholders' Equity

Current liabilities		
Accounts payable	\$ 100,000	\$ 60,000
Accrued liabilities	30,000	20,000
Total current liabilities	130,000	80,000
Stockholders' equity		
Common stock (\$10 par)	220,000	30,000
Additional paid-in capital	140,000	100,000
Retained earnings	620,000	140,000
Total stockholders' equity	980,000	270,000
Total liabilities and stockholders' equity	<u>\$1,110,000</u>	<u>\$350,000</u>

*The items omitted can be found in other Content Specification Groups.

INCOME STATEMENTS For the Year Ended December 31, 1986

	<u>Par</u>	<u>Sub</u>
Sales	\$1,000,000	\$300,000
Cost of goods sold	770,000	200,000
Gross margin	230,000	100,000
Other operating expenses	130,000	50,000
Operating income	100,000	50,000
Equity in earnings of Sub	25,000	—
Income before income taxes	125,000	50,000
Provision for income taxes	40,000	20,000
Net income	<u>\$ 85,000</u>	<u>\$ 30,000</u>

Additional information:

- On January 1, 1986, Par purchased for \$300,000 all of Sub's \$10 par, voting common stock. On January 1, 1986, the fair value of Sub's assets and liabilities equaled their carrying amount of \$330,000 and \$80,000, respectively. Par's policy is to amortize intangible assets over a 10-year period, unless a definite life is ascertainable.
- During 1986, Par and Sub paid cash dividends of \$50,000 and \$10,000, respectively. For tax purposes, Par receives the 100% exclusion for dividends received from Sub.
- There were no intercompany transactions except for Par's receipt of dividends from Sub, and Par's recording of its share of Sub's earnings.
- On June 30, 1986, Par issued 2,000 shares of common stock for \$17 per share. There were no other changes in either Par's or Sub's common stock during 1986.
- Both Par and Sub paid income taxes at the rate of 40%.

Selected Questions

4. In the 1986 consolidated income statement of Par and its subsidiary, Sub, what amount should be reported as consolidated net income?
 - a. \$ 60,000
 - b. \$ 85,000
 - c. \$ 90,000
 - d. \$115,000
5. The consolidated balance sheet of Par and its subsidiary, Sub, should report total consolidated assets of
 - a. \$1,110,000
 - b. \$1,145,000
 - c. \$1,190,000
 - d. \$1,460,000
6. The consolidated balance sheet of Par and its subsidiary, Sub, should report total retained earnings of
 - a. \$620,000
 - b. \$640,000
 - c. \$650,000
 - d. \$760,000
7. In the consolidated income statement of Par and its subsidiary, Sub, how much expense should be reported for amortization of goodwill?
 - a. \$0
 - b. \$ 3,000
 - c. \$ 5,000
 - d. \$10,000
9. In the December 31, 1986 consolidated balance sheet of Par and its subsidiary, Sub, how much should be reported as total current assets?
 - a. \$150,000
 - b. \$280,000
 - c. \$430,000
 - d. \$580,000

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

A. Cash, Marketable Securities, and Investments

1N88#1. Burr Company had the following account balances at December 31, 1987:

Cash in banks	\$2,250,000
Cash on hand	125,000
Cash legally restricted for additions to plant (expected to be disbursed in 1988)	1,600,000

Cash in banks includes \$600,000 of compensating balances against short-term borrowing arrangements. The compensating balances are not legally restricted as to withdrawal by Burr. In the current assets section of Burr's December 31, 1987 balance sheet, total cash should be reported at

- a. \$1,775,000
- b. \$2,250,000
- c. \$2,375,000
- d. \$3,975,000

1N88#14. On January 15, 1988, Carr Corp. adopted a plan to accumulate funds for environmental improvements beginning July 1, 1992, at an estimated cost of \$2,000,000. Carr plans to make four equal annual deposits in a fund that will earn interest at 10% com-

pounded annually. The first deposit was made on July 1, 1988. Future value and future amount factors are as follows:

Future value of 1 at 10% for 5 periods	1.61
Future amount of ordinary annuity of 1 at 10% for 4 periods	4.64
Future amount of annuity in advance of 1 at 10% for 4 periods	5.11

Carr should make four annual deposits (rounded) of

- a. \$322,000
- b. \$391,400
- c. \$431,000
- d. \$500,000

1N88#15. On January 1, 1987, Grey Company purchased as a long-term investment 400 of the \$1,000 face amount, 8% bonds of Winn Corp. for \$369,000 to yield 10% annually. The bonds pay interest semiannually on July 1 and January 1, and mature on January 1, 1992. Grey uses the interest method of amortization. The bonds should be reported (rounded) on Grey's December 31, 1987 balance sheet at

- a. \$363,980
- b. \$364,100
- c. \$373,900
- d. \$374,020

Accounting Practice

1M88#1. Burr Corp. began operations on January 1, 1987, and at December 31, 1987, Burr had the following investment portfolios of marketable equity securities:

	<u>In current assets</u>	<u>In noncurrent assets</u>
Aggregate cost	\$185,000	\$275,000
Aggregate market value	150,000	225,000
Net unrealized loss	<u>\$ 35,000</u>	<u>\$ 50,000</u>

All the declines are judged to be temporary. Valuation allowances at December 31, 1987 should be established with corresponding charges against

	<u>Income</u>	<u>Stockholders' equity</u>
a.	\$0	\$85,000
b.	\$35,000	\$50,000
c.	\$50,000	\$35,000
d.	\$85,000	\$0

1M88#12. In preparing its bank reconciliation at December 31, 1987, Case Company has available the following data:

Balance per bank statement, 12/31/87	\$38,075
Deposit in transit, 12/31/87	5,200
Outstanding checks, 12/31/87	6,750
Amount erroneously credited by bank to Case's account, 12/28/87	400
Bank service charges for December	75

Case's adjusted cash in bank balance at December 31, 1987 is

- \$36,525
- \$36,450
- \$36,125
- \$36,050

1M88#18. On December 31, 1986, Wall Company purchased marketable equity securities as a temporary investment. Pertinent data are as follows:

<u>Security</u>	<u>Cost</u>	<u>Market value at 12/31/87</u>
A	\$39,000	\$36,000
B	50,000	55,000
C	96,000	85,000

On December 31, 1987, Wall reclassified its investment in security C from current to noncurrent because Wall intends to retain security C as a long-term investment. What total amount of loss on its securities should be included in Wall's income statement for the year ended December 31, 1987?

- \$0
- \$ 9,000
- \$11,000
- \$14,000

1N87#1. Apex Corporation's checkbook balance on December 31, 1986, was \$160,000. The same date Apex held the following items in its safe:

- A \$5,000 check payable to Apex, dated January 2, 1987, that was not included in the December 31 checkbook balance.
- A \$3,500 check payable to Apex, deposited December 22 and included in the December 31 checkbook balance, that was returned by the bank on December 30 marked NSF. The check was redeposited January 2, 1987, and cleared January 7.
- A \$25,000 check, payable to a supplier and drawn on Apex's account, that was dated and recorded December 31, but was not mailed until January 15, 1987.

In its December 31, 1986 balance sheet, Apex should report cash at

- \$156,500
- \$161,500
- \$181,500
- \$185,000

1N87#2. During 1985 Garr Company purchased marketable equity securities as a short-term investment. At December 31, 1985, the balance in the allowance to reduce marketable equity securities to market was \$23,000. There were no security transactions during 1986. Pertinent information at December 31, 1986, is as follows:

<u>Security</u>	<u>Cost</u>	<u>Market value</u>
A	\$245,000	\$230,000
B	180,000	182,000
	<u>\$425,000</u>	<u>\$412,000</u>

In its 1986 income statement, Garr should report a (an)

- Recovery of unrealized loss of \$8,000.
- Recovery of unrealized loss of \$10,000.
- Unrealized loss of \$13,000.
- Unrealized loss of \$15,000.

1N87#3. On July 1, 1986, Fox Company purchased 400 of the \$1,000 face amount, 8% bonds of Dey Corporation for \$369,200 to yield 10% per annum. The bonds, which mature on July 1, 1991, pay interest semi-annually on January 1 and July 1. Fox uses the interest method of amortization and the bonds are appropriately recorded as a long-term investment. The bonds should be reported on Fox's December 31, 1986 balance sheet at

- \$397,540
- \$374,120
- \$371,660
- \$366,740

1N87#6. On January 1, 1987, Beal Corporation adopted a plan to accumulate funds for a new plant building to be erected beginning July 1, 1992, at an

Selected Questions

estimated cost of \$1,200,000. Beal intends to make five equal annual deposits in a fund that will earn interest at 8% compounded annually. The first deposit is made on July 1, 1987. Present value and future amount factors are as follows:

Present value of 1 at 8% for 5 periods	0.68
Present value of 1 at 8% for 6 periods	0.63
Future amount of ordinary annuity of 1 at 8% for 5 periods	5.87
Future amount of annuity in advance of 1 at 8% for 5 periods	6.34

Beal should make five annual deposits (rounded) of

- a. \$151,200
- b. \$163,200
- c. \$189,300
- d. \$204,400

1M87#1. On January 1, 1986, Carr Company purchased Fay Corp. 9% bonds with a face amount of \$400,000 for \$375,600, to yield 10%. The bonds are dated January 1, 1986, mature on December 31, 1995, and pay interest annually on December 31. Carr uses the interest method of amortizing bond discount. In its income statement for the year ended December 31, 1986, what total amount should Carr report as interest revenue from the long-term bond investment?

- a. \$40,000
- b. \$37,560
- c. \$36,000
- d. \$34,440

1M87

Items 3 and 4 are based on the following data:

Taft, Inc., began operations on January 1, 1986. At December 31, 1986, Taft had the following investment portfolios of marketable equity securities:

	<u>In current assets</u>	<u>In noncurrent assets</u>
Aggregate cost	\$180,000	\$275,000
Aggregate portfolio market value	160,000	225,000
Aggregate lower of cost or market value applied to each security in the portfolio	152,000	210,000

The market declines are judged to be temporary.

3. In its 1986 income statement, what amount should Taft report as unrealized loss on marketable equity securities?

- a. \$20,000
- b. \$28,000
- c. \$70,000
- d. \$93,000

4. In its December 31, 1986 balance sheet, Taft should report valuation allowances for current and non-current marketable equity securities respectively at

- a. \$20,000 and \$50,000.
- b. \$20,000 and \$0.
- c. \$28,000 and \$65,000.
- d. \$28,000 and \$50,000.

1M87#19. On January 2, 1986, Saxe Company purchased 20% of Lex Corporation's common stock for \$150,000. This investment did not give Saxe the ability to exercise significant influence over Lex. During 1986 Lex reported net income of \$175,000 and paid cash dividends of \$100,000 on its common stock. The balance in Saxe's investment in Lex Corporation account at December 31, 1986, should be

- a. \$130,000
- b. \$150,000
- c. \$165,000
- d. \$185,000

2N86#15. The following information pertains to Nu Co. at December 31, 1985:

Check book balance	\$6,000
Bank statement balance	8,000
Check drawn on Nu Co.'s account, payable to a vendor, dated and recorded, 12/31/85, but not mailed until 1/20/86	900

On Nu Co.'s balance sheet at December 31, 1985, how much should be shown as cash?

- a. \$6,000
- b. \$6,900
- c. \$7,100
- d. \$8,000

1M86#1. Orr Company had the following bank reconciliation at March 31, 1986:

Balance per bank statement, 3/31/86	\$46,500
Add: Deposit in transit	10,300
	56,800
Less: Outstanding checks	12,600
Balance per books, 3/31/86	<u>\$44,200</u>

Data per bank statement for the month of April 1986 follow:

Deposits	\$58,400
Disbursements	49,700

All reconciliation items at March 31, 1986, cleared through the bank in April. Outstanding checks at April 30, 1986, totaled \$7,500. What is the amount of cash disbursements per books in April?

- a. \$44,600
- b. \$49,700
- c. \$54,800
- d. \$57,200

Accounting Practice

1M86#2. On its December 31, 1984, balance sheet, Fay Company appropriately reported a \$2,000 credit balance in its Allowance to Reduce Temporary Investments to Lower of Cost or Market. There was no change during 1985 in the composition of Fay's portfolio of marketable equity securities held as a temporary investment. Pertinent data are as follows:

<u>Security</u>	<u>Cost</u>	<u>Market value at 12/31/85</u>
A	\$ 60,000	\$ 63,000
B	45,000	40,000
C	80,000	78,500
	<u>\$185,000</u>	<u>\$ 181,500</u>

What amount of loss on these securities should be included in Fay's income statement for the year ended December 31, 1985?

- a. \$0
- b. \$1,500
- c. \$3,500
- d. \$4,500

1M86#3. Neal Company held the following marketable securities as long-term investments at December 31, 1985:

	<u>Cost</u>	<u>Market value</u>
10,000 shares of Company A nonredeemable preferred stock, par value \$75	\$ 775,000	\$ 825,000
7,000 shares of Company B preferred stock, par value \$100, subject to mandatory redemption by the issuer at par on 12/31/90	690,000	625,000
	<u>\$1,465,000</u>	<u>\$1,450,000</u>

In Neal's December 31, 1985, balance sheet, marketable securities should be reported at

- a. \$1,400,000
- b. \$1,450,000
- c. \$1,465,000
- d. \$1,475,000

1M86#5. On January 1, 1985, Dell Company paid \$1,800,000 for 50,000 shares of Case Company's common stock which represents a 25% investment in the net assets of Case. Dell has the ability to exercise significant influence over Case. Dell received a dividend of \$3.50 per share from Case in 1985. Case reported net income of \$960,000 for the year ended December

31, 1985. In its December 31, 1985, balance sheet, Dell should report the investment in Case Company at

- a. \$2,215,000
- b. \$2,040,000
- c. \$1,865,000
- d. \$1,800,000

1N85#2. On December 31, 1984, West Company had the following cash balances:

Cash in banks	\$1,800,000
Petty cash funds (all funds were reimbursed on 12/31/84)	50,000

Cash in banks includes \$600,000 of compensating balances against short-term borrowing arrangements at December 31, 1984. The compensating balances are not legally restricted as to withdrawal by West. In the current assets section of West's December 31, 1984, balance sheet, what total amount should be reported as cash?

- a. \$1,200,000
- b. \$1,250,000
- c. \$1,800,000
- d. \$1,850,000

1N85#6. On October 1, 1984, Yost Company purchased 400 of the \$1,000 face value, 10% bonds of Pell, Inc., for \$440,000, which includes accrued interest of \$10,000. The bonds, which mature on January 1, 1991, pay interest semiannually on January 1 and July 1. Yost uses the straight-line method of amortization and appropriately recorded the bonds as a long-term investment. The bonds should be shown on Yost's December 31, 1984, balance sheet at

- a. \$428,400
- b. \$428,800
- c. \$430,000
- d. \$440,000

1M85#1. Fay Company had the following bank reconciliation at March 31, 1985:

Balance per bank statement, 3/31/85	\$23,250
Add deposit in transit	5,150
	<u>28,400</u>
Less outstanding checks	6,300
Balance per books, 3/31/85	<u>\$22,100</u>

Data per bank for the month of April 1985 follows:

Deposits	\$29,200
Disbursements	24,850

All reconciliation items at March 31, 1985, cleared through the bank in April. Outstanding checks at April

Selected Questions

30, 1985, totaled \$3,500. What is the balance of cash per books at April 30, 1985?

- a. \$31,100
- b. \$26,450
- c. \$24,100
- d. \$22,950

1M85#2. Butler Company had the following portfolio of current marketable equity securities at December 31, 1984:

<u>Security</u>	<u>Cost</u>	<u>Market value</u>
A	\$40,000	\$41,000
B	70,000	66,000

In Butler's December 31, 1984, balance sheet, the carrying value of the portfolio should be reported at

- a. \$106,000
- b. \$107,000
- c. \$110,000
- d. \$111,000

1M85#3. On April 1, 1984, Aldrich Company purchased as a temporary investment \$200,000 face value, 9% U.S. Treasury notes for \$198,500, which includes accrued interest of \$4,500. The notes mature July 1, 1985, and pay interest semiannually on January 1 and July 1. The notes were sold on December 1, 1984, for \$206,500, which includes accrued interest of \$7,500. In its income statement for the year ended December 31, 1984, what amount should Aldrich report as a gain on sale of marketable securities?

- a. \$1,800
- b. \$5,000
- c. \$6,500
- d. \$8,000

B. Receivables and Accruals

1M89#8. Taft Corp., which began business on January 1, 1987, appropriately uses the installment sales method of accounting. The following data are available for December 31, 1987 and 1988:

	<u>1987</u>	<u>1988</u>
Balance of deferred gross profit on sales account:		
1987	\$300,000	\$120,000
1988	—	440,000
Gross profit on sales	30%	40%

The installment accounts receivable balance at December 31, 1988 is

- a. \$1,000,000
- b. \$1,100,000
- c. \$1,400,000
- d. \$1,500,000

1M89#15. Fay, Inc., received a \$30,000, six-month, 12% interest-bearing note from a customer. The note was discounted the same day by Carr National Bank at 15%. The amount of cash received by Fay from the bank was

- a. \$30,000
- b. \$29,550
- c. \$29,415
- d. \$27,750

1M88#10. Roxy Company had the following information relating to its accounts receivable:

Accounts receivable at 12/31/86	\$1,300,000
Credit sales for 1987	5,400,000
Collections from customers for 1987	4,750,000
Accounts written off 9/30/87	125,000
Collection of accounts written off in prior years (customer credit was not reestablished)	25,000
Estimated uncollectible receivables per aging of receivables at 12/31/87	165,000

At December 31, 1987, Roxy's accounts receivable, before allowance for uncollectible accounts, should be

- a. \$1,825,000
- b. \$1,850,000
- c. \$1,950,000
- d. \$1,990,000

1M88#16. Apex Company accepted from a customer a \$100,000 face amount, 6-month, 8% note dated April 15, 1988. The same date Apex discounted the note at Union Bank at a 10% discount rate. How much cash should Apex receive from the bank on April 15, 1988?

- a. \$104,000
- b. \$ 99,000
- c. \$ 98,800
- d. \$ 97,200

1M88#18. On July 1, 1987, East Co. purchased as a long-term investment \$500,000 face amount, 8% bonds of Rand Corp. for \$461,500 to yield 10% per year. The bonds pay interest semiannually on January 1 and July 1. In its December 31, 1987 balance sheet, East should report interest receivable of

- a. \$18,460
- b. \$20,000
- c. \$23,075
- d. \$25,000

1M88#19. Bell, Inc. owns 60% of Dart Corporation's common stock. On December 31, 1987, Dart is indebted to Bell for a \$200,000 cash advance. In preparing the consolidated balance sheet at that date, what amount of the advance should be eliminated?

- a. \$0
- b. \$ 80,000
- c. \$120,000
- d. \$200,000

Accounting Practice

1M88#20. The following accounts were abstracted from Mann Company's unadjusted trial balance at December 31, 1987:

	<u>Debit</u>	<u>Credit</u>
Accounts receivable	\$1,000,000	
Allowance for doubtful accounts	8,000	
Net credit sales		\$4,000,000

Mann estimates that 3% of the gross accounts receivable will become uncollectible. After adjustment at December 31, 1987, the allowance for doubtful accounts should have a credit balance of

- a. \$ 22,000
- b. \$ 30,000
- c. \$ 38,000
- d. \$120,000

1N87#4. On January 1, 1986, Mann Company's allowance for doubtful accounts had a credit balance of \$30,000. During 1986 Mann charged \$64,000 to doubtful accounts expense, wrote off \$46,000 of uncollectible accounts receivable, and unexpectedly recovered \$12,000 of bad debts written off in the prior year. The allowance for doubtful accounts balance at December 31, 1986, would be

- a. \$48,000
- b. \$60,000
- c. \$64,000
- d. \$94,000

1N87#7. On December 31, 1986, Park Company sold used equipment to Ott Corp. and received a noninterest bearing note requiring payment of \$5,000 annually for ten years. The first payment is due December 31, 1987, and the prevailing rate of interest for this type of note at date of issuance is 12%. Present value factors are as follows:

Present value of 1 at 12% for 10 periods	0.322
Present value of ordinary annuity of 1 at 12% for 10 periods	5.650

In its December 31, 1986 balance sheet, Park should report the carrying amount of the note at

- a. \$16,100
- b. \$21,750
- c. \$28,250
- d. \$50,000

1M87#2. Dean, Inc., owns 100% of Roy Corporation, a consolidated subsidiary, and 80% of Wall, Inc., an unconsolidated subsidiary at December 31, 1986. The same date, Dean has receivables of \$200,000 from Roy and \$175,000 from Wall. In its December 31, 1986 consolidated balance sheet, Dean should report accounts receivable from investees at

- a. \$0
- b. \$35,000
- c. \$175,000
- d. \$235,000

1M87#6. On July 1, 1986, Park Company leased office space for ten years to Rudd at a monthly rental of \$15,000, and received the following amounts:

First month's rent	\$15,000
Security deposit	25,000

Rudd made timely rent payments through November 1986; the December rent was paid, together with the January 1987 rent, on January 6, 1987. At December 31, 1986, Park should report rent receivable of

- a. \$0
- b. \$ 5,000
- c. \$15,000
- d. \$30,000

1M87#12. Grey Company holds an overdue note receivable of \$800,000 plus recorded accrued interest of \$64,000. As the result of a court imposed settlement on December 31, 1986, Grey agreed to the following restructuring arrangement:

- Reduced the principal obligation to \$600,000.
- Forgave the \$64,000 accrued interest.
- Extended the maturity date to December 31, 1988.
- Annual interest of \$60,000 is to be paid to Grey on December 31, 1987 and 1988.

On December 31, 1986, Grey must recognize a loss from restructuring of

- a. \$144,000
- b. \$200,000
- c. \$204,000
- d. \$264,000

2N86#3. All of Ladd Co.'s sales are on a credit basis. The following information is available for 1985:

Allowance for doubtful accounts, 1/1/85	\$ 9,000
Sales	475,000
Sales returns	40,000
Accounts written off as uncollectible	10,000

Ladd provides for doubtful accounts expense at the rate of 3% of net sales. At December 31, 1985, the allowance for doubtful accounts balance should be

- a. \$14,050
- b. \$13,250
- c. \$13,050
- d. \$12,050

2N86#4. On June 30, 1985, Ray Co. discounted at the bank a customer's \$60,000, 6-month, 10% note receivable dated April 30, 1985. The bank discounted the note at 12%. Ray's proceeds from this discounted note amounted to

- a. \$56,400
- b. \$57,600
- c. \$60,480
- d. \$61,740

Selected Questions

2N86#16. An analysis and aging of Jay Co.'s accounts receivable at December 31, 1985, disclosed the following:

Accounts receivable	\$900,000
Allowance for uncollectible accounts, per books	50,000
Accounts estimated to be uncollectible	64,000

At December 31, 1985, the net realizable value of accounts receivable should be

- a. \$886,000
- b. \$850,000
- c. \$836,000
- d. \$786,000

1M86

Items 6 and 7 are based on the following data:

Rex Company had the following information relating to its accounts receivable at December 31, 1984, and for the year ended December 31, 1985:

Accounts receivable at 12/31/84	\$1,200,000
Allowance for doubtful accounts at 12/31/84	60,000
Credit sales for 1985	5,300,000
Collections from customers for 1985	4,650,000
Accounts written off 9/30/85	75,000
Estimated uncollectible receivables per aging of receivables at 12/31/85	110,000

6. At December 31, 1985, Rex's allowance for doubtful accounts should be

- a. \$135,000
- b. \$125,000
- c. \$110,000
- d. \$ 95,000

7. At December 31, 1985, Rex's accounts receivable, before the allowance for doubtful accounts, should be

- a. \$1,850,000
- b. \$1,835,000
- c. \$1,815,000
- d. \$1,775,000

1M86#9. Cobb, Inc., has current receivables from affiliated companies at December 31, 1985, as follows:

- A \$75,000 cash advance to Hill Corporation. Cobb owns 30% of the voting stock of Hill and accounts for the investment by the equity method.
- A receivable of \$260,000 from Vick Corporation for administrative and selling services. Vick is 100% owned by Cobb and is included in Cobb's consolidated financial statements.
- A receivable of \$200,000 from Ward Corporation for merchandise sales on credit. Ward is a 90% owned, unconsolidated subsidiary of Cobb.

In the current assets section of its December 31, 1985, consolidated balance sheet, Cobb should report accounts receivable from investees in the total amount of

- a. \$180,000
- b. \$255,000
- c. \$275,000
- d. \$535,000

1N85#3. At the end of its first year of operations, December 31, 1984, Mill Company had accounts receivable of \$600,000, net of the related allowance for doubtful accounts. During 1984 Mill recorded charges to bad debt expense of \$90,000 and wrote off \$20,000 of uncollectible accounts receivable. In its December 31, 1984, balance sheet, how much should Mill report as accounts receivable before the allowance for doubtful accounts?

- a. \$600,000
- b. \$620,000
- c. \$670,000
- d. \$710,000

1M85#5. An analysis and aging of the accounts receivable of Grey Company at December 31, 1984, revealed the following data:

Accounts receivable	\$900,000
Allowance for uncollectible accounts per books	50,000
Amounts deemed uncollectible	64,000

The net realizable value of the accounts receivable at December 31, 1984, should be

- a. \$886,000
- b. \$850,000
- c. \$836,000
- d. \$786,000

1M85#6. On August 1, 1984, Kern Company leased a machine to Day Company for a six-year period requiring payments of \$10,000 at the beginning of each year. The machine cost \$48,000, which is the fair value at the lease date, and has a useful life of eight years with no residual value. Kern's implicit interest rate is 10% and present value factors are as follows:

Present value of an annuity due of \$1 at 10% for 6 periods	4.791
Present value of an annuity due of \$1 at 10% for 8 periods	5.868

Kern appropriately recorded the lease as a direct financing lease. At the inception of the lease, the gross lease receivables account balance should be

- a. \$60,000
- b. \$58,680
- c. \$48,000
- d. \$47,910

Accounting Practice

1M85#7. Pine Company provides for doubtful accounts expense at the rate of 2% of credit sales. The following data are available for 1984:

Allowance for doubtful accounts, 1/1/84	\$ 18,000
Accounts written off as uncollectible during 1984	20,000
Collection of accounts written off in prior years (customer credit was reestablished)	5,000
Credit sales year ended 12/31/84	1,500,000

The allowance for doubtful accounts balance at December 31, 1984, should be

- a. \$33,000
- b. \$30,000
- c. \$28,000
- d. \$15,000

1M85#9. Weaver, Inc., received a \$60,000, six-month, 12% interest-bearing note from a customer. The note was discounted the same day at Third National Bank at 15%. The amount of cash received by Weaver from the bank was

- a. \$64,770
- b. \$63,600
- c. \$59,100
- d. \$58,830

C. Inventories

1M89#21. Grey Corp. purchased merchandise with a list price of \$20,000, subject to trade discounts of 10% and 5%. What amount should Grey record as the cost of this merchandise?

- a. \$17,000
- b. \$17,100
- c. \$17,900
- d. \$20,000

1M89#22. At December 31, 1988, the following information was available from Huff Co.'s accounting records:

	<u>Cost</u>	<u>Retail</u>
Inventory, 1/1/88	\$147,000	\$ 203,000
Purchases	833,000	1,155,000
Additional markups	—	42,000
Available for sale	<u>\$980,000</u>	<u>\$1,400,000</u>

Sales for the year totaled \$1,106,000. Markdowns amounted to \$14,000. Under the approximate lower of average cost or market retail method, Huff's inventory at December 31, 1988 was

- a. \$308,000
- b. \$280,000
- c. \$215,600
- d. \$196,000

1N88#17. Dell Company's inventory at December 31, 1987 was \$1,200,000 based on a physical count of goods priced at cost, and before any necessary year-end adjustments relating to the following:

- Included in the physical count were goods billed to a customer F.O.B. shipping point on December 30, 1987. These goods had a cost of \$25,000 and were picked up by the carrier on January 7, 1988.
- Goods shipped F.O.B. shipping point on December 28, 1987, from a vendor to Dell were received on January 4, 1988. The invoice cost was \$60,000.

What amount should Dell report as inventory in its December 31, 1987 balance sheet?

- a. \$1,175,000
- b. \$1,200,000
- c. \$1,235,000
- d. \$1,260,000

1N88#19. Kew Company recorded the following data pertaining to raw material X during January 1988:

<u>Date</u>	<u>Units</u>			
	<u>Received</u>	<u>Cost</u>	<u>Issued</u>	<u>On hand</u>
1/1/88				
Inventory		\$4.00		1,600
1/11/88				
Issue			800	800
1/22/88				
Purchase	2,400	\$4.80		3,200

The moving-average unit cost of X inventory at January 31, 1988, is

- a. \$4.80
- b. \$4.60
- c. \$4.48
- d. \$4.40

1M88#21. Ward Distribution Company has determined its December 31, 1987 inventory on a FIFO basis at \$200,000. Information pertaining to that inventory follows:

Estimated selling price	\$204,000
Estimated cost of disposal	10,000
Normal profit margin	30,000
Current replacement cost	180,000

Ward records losses that result from applying the lower of cost or market rule. At December 31, 1987, the loss that Ward should recognize is

- a. \$0
- b. \$ 6,000
- c. \$14,000
- d. \$20,000

Selected Questions

1M88#22. On January 1, 1986, Poe Company adopted the dollar-value LIFO inventory method. Poe's entire inventory constitutes a single pool. Inventory data for 1986 and 1987 are as follows:

Date	Inventory at current year cost	Inventory at base year cost	Relevant price index
1/1/86	\$150,000	\$150,000	1.00
12/31/86	220,000	200,000	1.10
12/31/87	276,000	230,000	1.20

Poe's LIFO inventory value at December 31, 1987 is

- \$230,000
- \$236,000
- \$241,000
- \$246,000

1N87#5. Kemp Company had the following consignment transactions during December 1986:

Inventory shipped on consignment to Ashe Company	\$9,000
Freight paid by Kemp	450
Inventory received on consignment from Fenn Company	6,000
Freight paid by Fenn	250

No sales of consigned goods were made through December 31, 1986. Kemp's December 31, 1986 balance sheet should include consigned inventory at

- \$9,450
- \$9,000
- \$6,250
- \$6,000

1N87#9. Dart Company's accounting records indicated the following information:

Inventory, 1/1/86	\$ 500,000
Purchases during 1986	2,500,000
Sales during 1986	3,200,000

A physical inventory taken on December 31, 1986, resulted in an ending inventory of \$575,000. Dart's gross profit on sales has remained constant at 25% in recent years. Dart suspects some inventory may have been taken by a new employee. At December 31, 1986, what is the estimated cost of missing inventory?

- \$ 25,000
- \$100,000
- \$175,000
- \$225,000

1M87#16. Evan Company adopted the dollar value LIFO inventory method on December 31, 1985. Evan's entire inventory constitutes a single pool. On Decem-

ber 31, 1985, the inventory was \$300,000 under the dollar value LIFO method. Inventory data for 1986 are as follows:

12/31/86 inventory at year-end prices	\$390,000
Relevant price index at year-end (base year 1985)	120

Using dollar value LIFO, Evan's inventory at December 31, 1986, is

- \$325,000
- \$330,000
- \$360,000
- \$390,000

1M87#17. On July 1, 1986, Link Development Company purchased a tract of land for \$900,000. Additional costs of \$150,000 were incurred in subdividing the land during July through December 1986. Of the tract acreage, 70% was subdivided into residential lots as shown below and 30% was conveyed to the city for roads and a park.

Lot class	Number of lots	Sales price per lot
A	100	\$12,000
B	100	8,000
C	200	5,000

Under the relative sales value method, the cost allocated to each Class A lot should be

- \$2,625
- \$2,940
- \$3,600
- \$4,200

2N86#1. The following information pertains to an item in Bay Co.'s inventory at year end:

Cost	\$1.50
Replacement cost	.60
Net realizable value	1.20
Net realizable value less normal profit	.84

Under the lower of cost or market approach, how much is the year-end inventory value of this item?

- \$1.20
- \$.84
- \$.66
- \$.60

2N86#13. Day Retailers purchased merchandise with a list price of \$10,000, subject to trade discounts of 20% and 10%, with no cash discounts allowable. How much should Day record as the cost of this merchandise?

- \$10,000
- \$ 7,800
- \$ 7,200
- \$ 7,000

Accounting Practice

1M86#4. Dean Sportswear, Inc., regularly buys sweaters from Mill Company and is allowed a trade discount of 30% from the list price. Dean made a purchase on March 20, 1986, and received an invoice with a list price of \$6,000, a freight charge of \$150, and payment terms of net 30 days. Dean should record the purchase at

- a. \$4,200
- b. \$4,350
- c. \$6,000
- d. \$6,150

1M86#12. On December 31, 1984, Jason Company adopted the dollar value LIFO retail inventory method. Inventory data for 1985 are as follows:

	<u>LIFO cost</u>	<u>Retail</u>
Inventory, 12/31/84	\$360,000	\$500,000
Inventory, 12/31/85	?	660,000
Increase in price level for 1985		10%
Cost to retail ratio for 1985		70%

Under the LIFO retail method, Jason's inventory at December 31, 1985, should be

- a. \$437,000
- b. \$462,000
- c. \$472,000
- d. \$483,200

1N85#5. The following information appears in Dix Company records for the year ended December 31, 1984:

Merchandise inventory, 1/1/84	\$ 275,000
Purchases	1,125,000
Sales	1,500,000

On December 31, 1984, a physical inventory revealed that the ending inventory was only \$300,000. Dix's gross profit on sales has remained constant at 30% in recent years. Dix suspects that some inventory may have been pilfered by one of the new employees. At December 31, 1984, what is the estimated cost of missing inventory?

- a. \$ 25,000
- b. \$ 50,000
- c. \$ 75,000
- d. \$100,000

1N85#9. The following information applied to Ott Company for 1984:

Merchandise purchased for resale	\$600,000
Freight-in	15,000
Interest on notes payable to vendors	6,000
Purchase returns	3,000

Ott's inventoriable cost for 1984 was

- a. \$600,000
- b. \$603,000
- c. \$612,000
- d. \$618,000

1N85#10. The following information is available from the records of Bell Company for the year ended December 31, 1984:

	<u>At cost</u>	<u>At retail</u>
Inventory, 1/1/84	\$ 360,000	\$ 520,000
Purchases	1,320,000	1,840,000
Additional markups		40,000
Markdowns		160,000
Sales		1,920,000

Under the approximate lower of average cost or market retail method, Bell's inventory at December 31, 1984, is

- a. \$224,000
- b. \$240,000
- c. \$320,000
- d. \$480,000

1M85#8. Hall Company's inventory at December 31, 1984, was \$1,500,000 based on a physical count of goods priced at cost, and before any necessary year-end adjustment relating to the following:

- Included in the physical count were goods billed to a customer F.O.B. shipping point on December 31, 1984. These goods had a cost of \$30,000 and were picked up by the carrier on January 10, 1985.
- Goods shipped F.O.B. shipping point on December 28, 1984, from a vendor to Hall were received on January 4, 1985. The invoice cost was \$50,000.

What amount should Hall report as inventory on its December 31, 1984, balance sheet?

- a. \$1,470,000
- b. \$1,480,000
- c. \$1,520,000
- d. \$1,550,000

1M85#10. Marsh Company had 150 units of product A on hand at January 1, 1985, costing \$21 each. Purchases of product A during the month of January were as follows:

Selected Questions

	<u>Units</u>	<u>Unit cost</u>
Jan. 10	200	\$22
18	250	23
28	100	24

A physical count on January 31, 1985, shows 250 units of product A on hand. The cost of the inventory at January 31, 1985, under the LIFO method is

- a. \$5,850
- b. \$5,550
- c. \$5,350
- d. \$5,250

D. Property, Plant, and Equipment Owned or Leased

1M89#23. On January 2, 1989, Ashe Company entered into a ten-year noncancellable lease requiring year-end payments of \$100,000. Ashe's incremental borrowing rate is 12%, while the lessor's implicit interest rate, known to Ashe, is 10%. Present value factors for an ordinary annuity for ten periods are 6.145 at 10%, and 5.650 at 12%. Ownership of the property remains with the lessor at expiration of the lease. There is no bargain purchase option. The leased property has an estimated economic life of 12 years. What amount should Ashe capitalize for this leased property on January 2, 1989?

- a. \$1,000,000
- b. \$ 614,500
- c. \$ 565,000
- d. \$0

1M89#25. On January 2, 1989, Parke Corp. replaced its boiler with a more efficient one. The following information was available on that date:

Purchase price of new boiler	\$60,000
Carrying amount of old boiler	5,000
Fair value of old boiler	2,000
Installation cost of new boiler	8,000

The old boiler was sold for \$2,000. What amount should Parke capitalize as the cost of the new boiler?

- a. \$68,000
- b. \$66,000
- c. \$63,000
- d. \$60,000

1M89#26. Frey, Inc. purchased a machine for \$450,000 on January 2, 1987. The machine has an estimated useful life of four years and a salvage value of \$50,000. The machine is being depreciated using the sum-of-the-years' digits method. The December 31, 1988 asset balance, net of accumulated depreciation, should be

- a. \$290,000
- b. \$270,000
- c. \$170,000
- d. \$135,000

1M89#27. On January 1, 1985, Evan Company purchased a machine for \$400,000 and established an annual depreciation charge of \$50,000 over an eight-year life. During 1988, after issuing its 1987 financial statements, Evan concluded that: (1) the machine suffered permanent impairment of its operational value, and (2) \$100,000 is a reasonable estimate of the amount expected to be recovered through use of the machine for the period January 1, 1988 to December 31, 1992. In Evan's December 31, 1988 balance sheet, the machine should be reported at a carrying amount of

- a. \$200,000
- b. \$ 80,000
- c. \$ 50,000
- d. \$0

1M88#23. During 1987, Fox Company made the following expenditures relating to plant machinery and equipment:

- Renovation of a group of machines at a cost of \$50,000 to secure greater efficiency in production over their remaining five-year useful lives. The project was completed on December 31, 1987.
- Continuing, frequent, and low cost repairs at a cost of \$35,000.
- A broken gear on a machine was replaced at a cost of \$5,000.

What total amount should be charged to repairs and maintenance in 1987?

- a. \$35,000
- b. \$40,000
- c. \$85,000
- d. \$90,000

1M88#24. On January 1, 1985, Parr, Inc. purchased a machine for \$600,000 and established an annual depreciation charge of \$100,000 over a six-year life. During 1987, after issuing its 1986 financial statements, Parr concluded that the machine's operational value was permanently impaired. It also concluded that \$120,000 is a reasonable estimate of the total amount expected to be recovered through remaining use of the machine for the period January 1, 1987 through December 31, 1989. In Parr's December 31, 1987 balance sheet, the machine should be reported at a carrying amount of

- a. \$ 80,000
- b. \$120,000
- c. \$300,000
- d. \$360,000

Accounting Practice

1M88#25. On March 1, 1987, Kay Company purchased for \$450,000 a tract of land as a factory site. An existing building on the property was razed and construction was begun on a new factory building in April 1987. Additional data are available as follows:

Cost of razing old building	\$ 60,000
Title insurance and legal fees to purchase land	30,000
Architect's fees	95,000
New building construction cost	1,850,000

The capitalized cost of the completed factory building should be

- a. \$2,005,000
- b. \$1,975,000
- c. \$1,945,000
- d. \$1,910,000

1M87#7. On December 1, 1986, Terry Company signed a 10-year nonrenewable lease for a building to be used in its manufacturing operations. During the latter part of December 1986 Terry incurred the following costs:

- \$96,000 for general improvements to the premises.
- \$48,000 for moveable assembly line equipment.
- \$120,000 for office furniture and equipment.

In its December 31, 1986 balance sheet, Terry should report leasehold improvements of

- a. \$ 96,000
- b. \$144,000
- c. \$216,000
- d. \$264,000

1M87#8. On January 1, 1986, Huff Company owned a machine having a carrying amount of \$240,000. The machine was purchased four years earlier for \$400,000. Huff uses straight-line depreciation. During December 1986 Huff determined that the machine suffered permanent impairment of its operational value and will not be economically useful in its production process after December 31, 1986. Huff sold the machine for \$65,000 on January 5, 1987. In its income statement for the year ended December 31, 1986, Huff should recognize a loss of

- a. \$200,000
- b. \$175,000
- c. \$135,000
- d. \$0

1M87#9. On June 30, 1986, a fire in Pine Company's plant caused a total loss to a production machine. The machine was being depreciated at \$20,000 annually and had a carrying amount of \$160,000 at December 31, 1985. On the date of the fire the fair value of the ma-

chine was \$220,000, and Pine received insurance proceeds of \$200,000 in October 1986. In its income statement for the year ended December 31, 1986, what amount should Pine recognize as a gain or loss on disposition?

- a. \$0.
- b. \$20,000 loss.
- c. \$40,000 gain.
- d. \$50,000 gain.

1N86#2. On January 2, 1986, Conn Company replaced its old high-pressure steam boiler with a more efficient oil-burning boiler. The following information was available on that date:

Carrying amount of old boiler	\$ 4,000
Fair value of old boiler	1,000
Purchase and installation price of the new boiler	50,000

The old boiler was sold to a heating contractor for \$1,000. How much should Conn capitalize as the cost of the new boiler?

- a. \$50,000
- b. \$49,000
- c. \$47,000
- d. \$46,000

1N86#3. On June 30, 1986, Kent Company completed the rearrangement of a group of factory machines to secure greater efficiency in production. Kent estimated that benefits from the rearrangement would extend over the remaining five-year useful lives of the machines. The following costs were incurred:

Moving	\$35,000
Reinstallation	75,000
Annual maintenance (performed at this time for convenience)	10,000

How much of the costs incurred should be capitalized on June 30, 1986?

- a. \$0
- b. \$ 75,000
- c. \$110,000
- d. \$120,000

2N86#2. Saba Co. bought a tract of land, paying \$800,000 in cash and assuming an existing mortgage of \$200,000. The municipal tax bill disclosed an assessed valuation of \$700,000. How much should Saba record as an asset for this land acquisition?

- a. \$ 600,000
- b. \$ 700,000
- c. \$ 800,000
- d. \$1,000,000

Selected Questions

2N86

Items 7 through 10* are based on the following data:

When Key Co. commenced business operations on January 1, 1983, the following assets were among those acquired at that date:

Real estate

Cost of parcel of land	\$ 20,000
Cost of razing old structure which had been on the land	3,000
Title insurance and legal fees pertaining to land acquisition	5,000
Architect's fees	30,000
Cost of constructing new building	600,000

Machinery

Cost	100,000
Residual value	10,000
Estimated useful life (double-declining-balance method)	4 years

In 1985, Key incurred the following losses:

Foreign exchange loss because of major devaluation of foreign currency	\$ 17,000
Effects of a strike against Key's major supplier	120,000

Also during 1985, the following gains were recognized:

Income tax benefit arising from operating loss carryforward	\$ 80,000
Gain on sale of real estate used in operations	300,000

7. How much should Key have capitalized in 1983 as the cost of the new building?

- a. \$600,000
- b. \$630,000
- c. \$635,000
- d. \$638,000

8. At December 31, 1984, after Key's second year of operations, how much was the accumulated depreciation on the machinery?

- a. \$45,000
- b. \$50,000
- c. \$67,500
- d. \$75,000

1M86#15. On January 2, 1983, Wayne, Inc., signed an eight-year lease for office space. Wayne has the option to renew the lease for an additional four-year period on or before January 2, 1990. During January 1985, two years after occupying the leased premises, Wayne made general improvements to the premises

costing \$360,000 and having an estimated useful life of ten years. At December 31, 1985, Wayne's intentions as to exercise of the renewal option are uncertain because they depend upon future office space requirements. A full year's amortization expense is taken for calendar year 1985. Wayne should record amortization of leasehold improvements for 1985 at

- a. \$30,000
- b. \$36,000
- c. \$45,000
- d. \$60,000

1M86#16. During 1985 King Company made the following expenditures relating to its plant building:

Continuing and frequent repairs	\$40,000
Repainted the plant building	10,000
Major improvements to the electrical wiring system	32,000
Partial replacement of roof tiles	14,000

How much should be charged to repair and maintenance expense in 1985?

- a. \$96,000
- b. \$82,000
- c. \$64,000
- d. \$54,000

1M86#19. On September 10, 1985, Landy Company incurred the following costs for one of its printing presses:

Purchase of stapling attachment	\$45,000
Installation of attachment	10,000
Replacement parts for renovation of press	30,000
Labor and overhead in connection with renovation of press	14,000

Neither the attachment nor the renovation increased the estimated useful life of the press. However, the renovation resulted in significantly increased productivity. What amount of the costs should be capitalized?

- a. \$0
- b. \$44,000
- c. \$55,000
- d. \$99,000

1N85#11. Clay Company started construction of a new office building on January 1, 1984, and moved into the finished building on July 1, 1985. Of the building's \$2,500,000 total cost, \$2,000,000 was incurred in 1984 evenly throughout the year. Clay's incremental borrowing rate was 12% throughout 1984, and the total amount of interest incurred by Clay during 1984 was \$102,000. What amount should Clay report as capitalized interest at December 31, 1984?

- a. \$102,000
- b. \$120,000
- c. \$150,000
- d. \$240,000

*The items omitted can be found in other Content Specification Groups.

Accounting Practice

1N85#12. On July 1, 1985, Town Company purchased for \$540,000 a warehouse building and the land on which it is located. The following data were available concerning the property:

	<i>Current appraised value</i>	<i>Seller's original cost</i>
Land	\$200,000	\$140,000
Warehouse building	300,000	280,000
	<u>\$500,000</u>	<u>\$420,000</u>

Town should record the land at

- a. \$140,000
- b. \$180,000
- c. \$200,000
- d. \$216,000

1N85#13. On July 1, 1985, a fire destroyed \$200,000 of Lane Company's \$600,000 inventory (fair market values). Lane carried a \$240,000 fire insurance policy with an 80% co-insurance clause. What is the maximum amount of insurance that Lane can collect as a result of this loss?

- a. \$200,000
- b. \$192,000
- c. \$160,000
- d. \$100,000

1N85#15. On January 2, 1984, Terry Company signed a ten-year noncancellable lease for a machine, stipulating annual payments of \$20,000 starting at the end of the first year, with title passing to Terry at the expiration of the lease. The machine has an estimated useful life of 12 years, with no salvage value. Terry uses straight-line depreciation for all of its fixed assets. Aggregate lease payments were determined to have a present value of \$123,000, based on implicit interest of 10%. For 1984, Terry should record depreciation (amortization) of

- a. \$0
- b. \$10,250
- c. \$12,300
- d. \$20,000

1N85#19. On December 31, 1984, a building owned by Glen Company was totally destroyed by fire. The building was covered by a fire insurance policy with a face value of \$250,000. Other pertinent information as of December 31, 1984, is as follows:

Building — at book value	\$260,000
Building — at fair value	275,000
Removal and clean-up cost	3,000

During January 1985, before the 1984 financial statements were issued, Glen received insurance proceeds

of \$250,000. What amount should Glen report on its 1984 income statement as involuntary conversion loss?

- a. \$10,000
- b. \$13,000
- c. \$25,000
- d. \$28,000

1N85#26. On January 1, 1981, Bart Company purchased equipment at a cost of \$105,000. The equipment was estimated to have a useful life of five years and a salvage value of \$15,000. Bart uses the sum-of-the-years'-digits method of depreciation. What should the accumulated depreciation be at December 31, 1984?

- a. \$98,000
- b. \$84,000
- c. \$70,000
- d. \$60,000

E. Intangibles and Other Assets

1M89#28. Pine Football Company had a player contract with Duff that is recorded in its books at \$500,000 on July 1, 1988. Ace Football Company had a player contract with Terry that is recorded in its books at \$600,000 on July 1, 1988. On this date, Pine traded Duff to Ace for Terry and paid a cash difference of \$50,000. The fair value of the Terry contract was \$700,000 on the exchange date. After the exchange, the Terry contract should be recorded in Pine's books at

- a. \$550,000
- b. \$600,000
- c. \$650,000
- d. \$700,000

1M89#29. On April 1, 1988, Hart, Inc. paid \$1,700,000 for all the issued and outstanding common stock of Ray Corp. On that date, the costs and fair values of Ray's recorded assets and liabilities were as follows:

	<i>Cost</i>	<i>Fair value</i>
Cash	\$ 160,000	\$ 160,000
Inventory	480,000	460,000
Property, plant and equipment (net)	980,000	1,040,000
Liabilities	(360,000)	(360,000)
Net assets	<u>\$1,260,000</u>	<u>\$1,300,000</u>

Hart amortizes goodwill over 40 years. In Hart's March 31, 1989 balance sheet, what is the amount of goodwill that should be reported as a result of this business combination?

- a. \$390,000
- b. \$400,000
- c. \$429,000
- d. \$440,000

Selected Questions

1N88#11. On February 15, 1988, Saxe Corp. paid \$3,000,000 for all the issued and outstanding common stock of Carr, Inc., in a business combination properly accounted for as a purchase. The carrying amounts and fair values of Carr's assets and liabilities on February 15, 1988, were as follows:

	<i>Carrying amount</i>	<i>Fair value</i>
Cash	\$ 320,000	\$ 320,000
Receivables	360,000	360,000
Inventory	580,000	540,000
Property, plant and equipment	1,740,000	1,920,000
Liabilities	(700,000)	(700,000)
Stockholders' equity	<u>\$2,300,000</u>	<u>\$2,440,000</u>

What is the amount of goodwill resulting from the business combination?

- a. \$700,000
- b. \$560,000
- c. \$140,000
- d. \$0

1N88#12. On January 1, 1987, Kew Corp. incurred organization costs of \$24,000. For financial accounting purposes, Kew is amortizing these costs on the same basis as the maximum allowable for Federal income tax purposes. What portion of the organization costs will Kew defer to years subsequent to 1987?

- a. \$23,400
- b. \$19,200
- c. \$ 4,800
- d. \$0

1N88#23. Rice Corp. adopted a defined benefit pension plan on January 1, 1986. The plan does not provide any retroactive benefits for existing employees. The pension funding payment is made to the trustee on December 31 each year. The following information is available for 1986 and 1987:

	<i>1986</i>	<i>1987</i>
Service cost	\$150,000	\$165,000
Funding payment	170,000	185,000
Interest on projected benefit obligation	—	15,000
Actual return on plan assets	—	18,000
Experience gains or losses	—	—

Rice chose early adoption of the FASB Statement on Employers' Accounting for Pensions. In its December 31, 1987 balance sheet, Rice should report prepaid pension cost of

- a. \$20,000
- b. \$25,000
- c. \$40,000
- d. \$43,000

1N88#24. Kemp Company purchased a patent on January 1, 1984, for \$357,000. The patent was being amortized over its remaining legal life of 15 years expiring on January 1, 1999. During 1987 Kemp determined that the economic benefits of the patent would not last longer than ten years from the date of acquisition. What amount should be reported in the balance sheet as patent, net of accumulated amortization, at December 31, 1987?

- a. \$261,800
- b. \$252,000
- c. \$244,800
- d. \$214,200

1M88#26. On July 1, 1987, Kemp Company leased office space for five years at \$15,000 a month. On that date, Kemp paid the lessor the following amounts:

Rent security deposit	\$ 35,000
First month's rent	15,000
Last month's rent	15,000
Nonrefundable reimbursement to lessor for modifications to the leased premises	<u>90,000</u>
	<u>\$155,000</u>

Kemp made timely rental payments August 1 through December 1, 1987. What portion of the payments to the lessor should Kemp have recognized as deferred to years beyond 1987?

- a. \$140,000
- b. \$131,000
- c. \$125,000
- d. \$ 50,000

1M88#27. Frey Corp. incurred \$175,000 of research and development costs in its laboratory to develop a patent granted on January 2, 1984. Legal fees and other costs associated with registration of the patent totaled \$35,000. On April 25, 1988, Frey paid \$50,000 for legal fees in a successful defense of the patent. The total amount capitalized for this patent through April 25, 1988 should be

- a. \$260,000
- b. \$210,000
- c. \$ 85,000
- d. \$ 35,000

1N87#10. Wall Company bought a trademark from Black Corporation on January 1, 1986, for \$112,000. An independent consultant retained by Wall estimated that the remaining useful life is 50 years. Its unamortized cost on Black's accounting records was \$56,000. Wall decided to write off the trademark over the maximum period allowed. How much should be amortized for the year ended December 31, 1986?

- a. \$1,120
- b. \$1,400
- c. \$2,240
- d. \$2,800

Accounting Practice

1N87#11. West Company adopted a defined benefit pension plan on January 1, 1986. West amortizes the prior service cost over 16 years and funds prior service cost by making equal payments to the fund trustee at the end of each of the first ten years. The service (normal) cost is fully funded at the end of each year. The following data are available for 1986:

Service (normal) cost for 1986	\$110,000
Prior service cost:	
Amortized	41,700
Funded	57,200

West's prepaid pension cost at December 31, 1986, is

- \$0
- \$15,500
- \$41,700
- \$57,200

1M87#10. On July 1, 1986, Hart signed an agreement to operate as a franchisee of Ace Printers for an initial franchise fee of \$120,000. The same date, Hart paid \$40,000 and agreed to pay the balance in four equal annual payments of \$20,000 beginning July 1, 1987. The down payment is not refundable and no future services are required of the franchisor. Hart can borrow at 14% for a loan of this type. Present and future value factors are as follows:

Present value of 1 at 14% for 4 periods	0.59
Future amount of 1 at 14% for 4 periods	1.69
Present value of an ordinary annuity of 1 at 14% for 4 periods	2.91

Hart should record the acquisition cost of the franchise on July 1, 1986, at

- \$135,200
- \$120,000
- \$ 98,200
- \$ 87,200

1M87#20. During 1986, Kay Company incurred \$102,000 of research and development costs in its laboratory to develop a patent which was granted on July 1, 1986. Legal fees and other costs associated with registration of the patent totaled \$20,500. The economic life of the patent is estimated at 10 years. What amount should Kay capitalize as a patent on July 1, 1986?

- \$0
- \$ 20,500
- \$102,000
- \$122,500

1N86#1. Ott Company acquired rights to a patent from Grey under a licensing agreement that required an advance royalty payment when the agreement was

signed. Ott remits royalties earned and due under the agreement on October 31 each year. Additionally, on the same date, Ott pays, in advance, estimated royalties for the next year. Ott adjusts prepaid royalties at year end. Information for the year ended December 31, 1985, is as follows:

<u>Date</u>		<u>Amount</u>
1/1/85	Prepaid royalties	\$ 65,000
10/31/85	Royalty payment (charged to royalty expense)	110,000
12/31/85	Year-end credit adjustment to royalty expense	25,000

In its December 31, 1985, balance sheet, Ott should report prepaid royalties of

- \$25,000
- \$40,000
- \$85,000
- \$90,000

1N86#5. On April 30, 1986, Star, Inc., purchased for \$30 per share all 200,000 of Wren Corp.'s outstanding common stock. On this date Wren's balance sheet showed net assets of \$5,000,000. Additionally, the fair value of Wren's identifiable assets on this date was \$600,000 in excess of their carrying amount. In Star's April 30, 1986, consolidated balance sheet, what amount should be reported as goodwill?

- \$0
- \$ 400,000
- \$ 600,000
- \$1,000,000

1M86#11. On December 31, 1985, Wall Company signed an agreement to operate as a franchisee of Fast Food, Inc., for an initial franchise fee of \$80,000. Of this amount, \$30,000 was paid when the agreement was signed and the balance is payable in five annual payments of \$10,000 each beginning December 31, 1986. The present value of the five payments, at an appropriate rate of interest, is \$36,000 at December 31, 1985. The agreement provides that the down payment is not refundable and no future services are required of the franchisor. Wall should report the franchise in its December 31, 1985, balance sheet at

- \$80,000
- \$66,000
- \$30,000
- \$0

1M86#14. Under Hart Company's accounting system, all insurance premiums paid are debited to prepaid insurance. For interim financial reports, Hart makes

Selected Questions

monthly estimated charges to insurance expense with credits to prepaid insurance. Additional information for the year ended December 31, 1985, is as follows:

Prepaid insurance at December 31, 1984	\$210,000
Charges to insurance expense during 1985 (including a year-end adjustment of \$35,000)	875,000
Unexpired insurance premiums at December 31, 1985	245,000

What was the total amount of insurance premiums paid by Hart during 1985?

- a. \$910,000
- b. \$875,000
- c. \$840,000
- d. \$665,000

1M86#18. On January 1, 1981, Vick Company purchased a trademark for \$400,000, having an estimated useful life of 16 years. In January 1985, Vick paid \$60,000 for legal fees in a successful defense of the trademark. Trademark amortization expense for the year ended December 31, 1985, should be

- a. \$0
- b. \$25,000

- c. \$28,750
- d. \$30,000

1M85#20. On December 1, 1984, Rhan Corporation leased office space for five years at a monthly rental of \$10,000. On that date Rhan paid the lessor the following amounts:

Rent security deposit	\$ 25,000
First month's rent	10,000
Last month's rent	10,000
Nonrefundable payment (reimburses lessor for modifications to the leased premises)	60,000
	<u>\$105,000</u>

The entire amount of \$105,000 was charged to rent expense in 1984. What portion of the payments should Rhan have deferred to years subsequent to 1984?

- a. \$35,000
- b. \$85,000
- c. \$94,000
- d. \$95,000

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

A. Payables and Accruals

1M89#24. The following information relating to compensated absences was available from Graf Company's accounting records at December 31, 1988:

- Employees' rights to vacation pay vest and are attributable to services already rendered. Payment is probable, and Graf's obligation was reasonably estimated at \$110,000.
- Employees' rights to sick pay benefits do not vest but accumulate for possible future use. The rights are attributable to services already rendered, and the total accumulated sick pay was reasonably estimated at \$50,000.

What amount is Graf required to report as the liability for compensated absences in its December 31, 1988 balance sheet?

- a. \$160,000
- b. \$110,000
- c. \$ 50,000
- d. \$0

1M89#30. Case Corp. had accounts payable of \$100,000 recorded in the general ledger as of December 31, 1988 before consideration of the following unrecorded transactions:

Invoice date	Amount	Date shipped	Date received	FOB terms
1-3-89	\$ 8,000	12-22-88	12-24-88	Destination
1-2-89	13,000	12-28-88	1-2-89	Shipping point
12-26-88	12,000	1-2-89	1-3-89	Shipping point
1-10-89	9,000	12-31-88	1-5-89	Destination
	<u>\$42,000</u>			

In Case's December 31, 1988 balance sheet, the accounts payable should be reported in the amount of

- a. \$100,000
- b. \$108,000
- c. \$121,000
- d. \$142,000

1M89#31. Robb Company requires advance payments with special orders from customers for machinery con-

Accounting Practice

structured to their specifications. Information for 1988 is as follows:

Customer advances — balance 12/31/87	\$295,000
Advances received with orders in 1988	460,000
Advances applied to orders shipped in 1988	410,000
Advances applicable to orders cancelled in 1988	125,000

At December 31, 1988, what amount should Robb report as a current liability for customer deposits?

- \$0
- \$220,000
- \$345,000
- \$370,000

1M89#32. Included in Witt Corp.'s liability account balances at December 31, 1988 were the following:

14% note payable issued October 1, 1988, maturing September 30, 1989	\$500,000
16% note payable issued April 1, 1986 payable in six equal annual installments of \$200,000 beginning April 1, 1987	800,000

Witt's December 31, 1988 financial statements were issued on March 31, 1989. On January 15, 1989, the entire \$800,000 balance of the 16% note was refinanced by issuance of a long-term obligation payable in a lump sum. In addition, on March 10, 1989, Witt consummated a noncancelable agreement with the lender to refinance the 14%, \$500,000 note on a long-term basis, on readily determinable terms that have not yet been implemented. Both parties are financially capable of honoring the agreement, and there have been no violations of the agreement's provisions. On the December 31, 1988 balance sheet, the amount of the notes payable that Witt should classify as short-term obligations is

- \$700,000
- \$500,000
- \$200,000
- \$0

1M89#33. Arno Corp.'s liability account balances at June 30, 1988 included a 10% note payable in the amount of \$1,800,000. The note is dated October 1, 1987 and is payable in three equal annual payments of \$600,000 plus interest. The first interest and principal payment was made on October 1, 1988. In Arno's June 30, 1989 balance sheet, what amount should be reported as accrued interest payable for this note?

- \$135,000
- \$ 90,000
- \$ 45,000
- \$ 30,000

1M89#35. As of December 31, 1987, the projected benefit obligation and plan assets of a noncontributory defined benefit plan sponsored by Reed, Inc. were:

Projected benefit obligation	\$780,000
Plan assets at fair value	600,000
Initial unfunded obligation	<u>\$180,000</u>

Reed elected to apply the provisions of FASB Statement No. 87, *Employers' Accounting for Pensions*, in its financial statements for the year ended December 31, 1988. At December 31, 1987, all amounts accrued as net periodic pension cost had been contributed to the plan. The average remaining service period of active plan participants expected to receive benefits was estimated to be 10 years at the date of transition. Some participants' estimated service periods are 20 and 25 years. To minimize an accrual for pension cost, what amount of unrecognized net obligation should Reed amortize?

- \$ 7,200
- \$ 9,000
- \$12,000
- \$18,000

1M89#36. Kent, Inc., a calendar year company, established a defined benefit pension plan in December 1987. The following data relate to this plan at December 31, 1988:

Projected benefit obligation	\$4,700,000
Accumulated benefit obligation	4,000,000
Total fair value of plan assets	3,000,000

Kent elected to apply the provisions of FASB Statement No. 87, *Employers' Accounting for Pensions*, in its financial statements for the year ended December 31, 1988.

In its December 31, 1988 balance sheet, Kent should report a minimum liability relating to the pension plan of

- \$4,000,000
- \$1,700,000
- \$1,000,000
- \$0

1M89#38. The Ward Corp.'s books showed income of \$300,000 before provision for income tax for the year ended December 31, 1988. In the computation of taxable income for federal income tax purposes, the following items should be noted:

Income from exempt municipal bonds	\$30,000
Depreciation deducted for tax purposes in excess of depreciation recorded on the books	\$60,000
Proceeds received for life insurance on death of officer	\$50,000
Estimated tax payments	\$0
Enacted corporate income tax rate	30%

Selected Questions

Ignore the alternate minimum tax provisions. What amount should Ward record as its current federal income tax liability at December 31, 1988?

- a. \$81,000
- b. \$75,000
- c. \$57,000
- d. \$48,000

1N88#13. Dean Company's accounts payable balance at December 31, 1987 was \$1,800,000 before considering the following transactions:

- Goods were in transit from a vendor to Dean on December 31, 1987. The invoice price was \$100,000, and the goods were shipped F.O.B. shipping point on December 29, 1987. The goods were received on January 4, 1988.
- Goods shipped to Dean, F.O.B. shipping point on December 20, 1987, from a vendor were lost in transit. The invoice price was \$50,000. On January 5, 1988, Dean filed a \$50,000 claim against the common carrier.

In its December 31, 1987 balance sheet, Dean should report accounts payable of

- a. \$1,950,000
- b. \$1,900,000
- c. \$1,850,000
- d. \$1,800,000

1M88#28. The balance in Reed Company's accounts payable account at December 31, 1987 was \$1,225,000 before the following information was considered:

- Goods shipped F.O.B. destination on December 21, 1987 from a vendor to Reed were lost in transit. The invoice cost of \$45,000 was not recorded by Reed. On December 28, 1987, Reed notified the vendor of the lost shipment.
- Goods were in transit from a vendor to Reed on December 31, 1987. The invoice cost was \$60,000, and the goods were shipped F.O.B. shipping point on December 28, 1987. Reed received the goods on January 6, 1988.

What amount should Reed report as accounts payable in its December 31, 1987 balance sheet?

- a. \$1,330,000
- b. \$1,285,000
- c. \$1,270,000
- d. \$1,225,000

1M88#29. On September 1, 1987, Howe Corp. offered special termination benefits to employees who had reached the early retirement age specified in the company's pension plan. The termination benefits consisted of lump-sum and periodic future payments. Additionally, the employees accepting the company offer receive the usual early retirement pension benefits. The

offer expired on November 30, 1987. Actual or reasonably estimated amounts at December 31, 1987 relating to the employees accepting the offer are as follows:

- Lump-sum payments totaling \$475,000 were made on January 1, 1988.
- Periodic payments of \$60,000 annually for three years will begin January 1, 1989. The present value at December 31, 1987, of these payments was \$155,000.
- Reduction of accrued pension costs at December 31, 1987 for the terminating employees was \$45,000.

In its December 31, 1987 balance sheet, Howe should report a total liability for special termination benefits of

- a. \$475,000
- b. \$585,000
- c. \$630,000
- d. \$655,000

1M88#30. Glen Corp. had the following data relating to its defined benefit pension plan at December 31, 1987:

Projected benefit obligation	\$4,000,000
Accumulated benefit obligation	3,500,000
Total fair value of plan assets	2,500,000

Glen chose early adoption of the FASB Statement on Employers' Accounting for Pensions for the year ended December 31, 1986. In its December 31, 1987 balance sheet, Glen should report a minimum liability relating to the pension plan of

- a. \$ 500,000
- b. \$1,000,000
- c. \$1,500,000
- d. \$3,500,000

1N87#8. Bloy Company pays all salaried employees on a biweekly basis. Overtime pay, however, is paid in the next biweekly period. Bloy accrues salaries expense only at its December 31 year end. Data relating to salaries earned in December 1986 are as follows:

- Last payroll was paid on 12/26/86, for the 2-week period ended 12/26/86.
- Overtime pay earned in the 2-week period ended 12/26/86 was \$4,200.
- Remaining work days in 1986 were December 29, 30, and 31, on which days there was no overtime.
- The recurring biweekly salaries total \$75,000.

Assuming a five-day work week, Bloy should record a liability at December 31, 1986, for accrued salaries of

- a. \$22,500
- b. \$26,700
- c. \$45,000
- d. \$49,200

Accounting Practice

1N87#12. On September 1, 1985, Pine Company issued a note payable to National Bank in the amount of \$1,800,000, bearing interest at 12%, and payable in three equal annual principal payments of \$600,000. On this date the bank's prime rate was 11%. The first interest and principal payment was made on September 1, 1986. At December 31, 1986, Pine should record accrued interest payable of

- a. \$44,000
- b. \$48,000
- c. \$66,000
- d. \$72,000

1N87#13. Lee Company's current liabilities at December 31, 1986, totaled \$1,500,000 before any necessary year-end adjustment relating to the following:

- On December 23, 1986, a vendor authorized Lee to return, for full credit, goods shipped and billed at \$45,000 on December 10, 1986. The returned goods were shipped by Lee on December 29, 1986. A \$45,000 credit memo was received and recorded by Lee on January 7, 1987.
- During December 1986, Lee received \$75,000 from Marr, a customer, as an advance payment for a bottling machine which Lee will construct to Marr's specifications. From this transaction Lee has a \$75,000 credit balance in its account receivable from Marr at December 31, 1986.

At December 31, 1986, what amount should Lee report as total current liabilities?

- a. \$1,455,000
- b. \$1,470,000
- c. \$1,530,000
- d. \$1,575,000

1N87#17. Dix, Inc., a calendar-year corporation, reported the following operating income (loss) before income tax for its first three years of operations:

1984	\$100,000
1985	(200,000)
1986	400,000

There are no permanent or timing differences between operating income (loss) for financial and income tax reporting purposes. When filing its 1985 tax return, Dix did not elect to forgo the carryback of its loss for 1985. Assume a 40% tax rate for all years. What amount should Dix report as its income tax liability at December 31, 1986?

- a. \$160,000
- b. \$120,000
- c. \$ 80,000
- d. \$ 60,000

1M87#5. On December 30, 1986, Case Company purchased a machine from Pitt in exchange for a noninterest bearing note requiring ten payments of \$10,000. The first payment was made on December 30, 1986, and the others are due annually on December 30. The

prevailing rate of interest for this type of note at date of issuance was 10%. Present value factors are as follows:

<u>Period</u>	<u>Present value of ordinary annuity of 1 at 10%</u>	<u>Present value of annuity in advance of 1 at 10%</u>
9	5.759	6.335
10	6.145	6.759

At December 31, 1986, the total note payable to Pitt was

- a. \$67,590
- b. \$63,350
- c. \$61,450
- d. \$57,590

1M87#11. Bain Company salaried employees are paid biweekly. Occasionally, advances made to employees are paid back by payroll deductions. Information relating to salaries for the calendar year 1986 is as follows:

	<u>12/31/85</u>	<u>12/31/86</u>
Employee advances	\$12,000	\$ 18,000
Accrued salaries payable	65,000	?
Salaries expense during the year		815,000
Salaries paid during the year (gross)		780,000

At December 31, 1986, what amount should Bain report for accrued salaries payable?

- a. \$100,000
- b. \$ 94,000
- c. \$ 82,000
- d. \$ 35,000

1M87#15. Cey Company has a defined benefit pension plan. Cey's policy is to fund net periodic pension cost annually, payment to an independent trustee being made two months after the end of each year. Data relating to the pension plan for 1986 are as follows:

Net pension cost for 1986	\$190,000
Unrecognized prior service cost, 12/31/86	150,000
Accumulated benefit obligation, 12/31/86	480,000
Fair value of plan assets, 12/31/86	500,000

How much should appear on Cey's balance sheet at December 31, 1986, for pension liability?

<u>Current</u>	<u>Noncurrent</u>
a. \$0	\$480,000
b. \$0	\$330,000
c. \$190,000	\$150,000
d. \$190,000	\$0

Selected Questions

1N86#4. Bell Company's current liabilities at December 31, 1985, totaled \$1,000,000 before any necessary year-end adjustment relating to the following:

- During December 1985 Bell received \$50,000 from Fox, a customer, as an advance payment for a packaging machine which Bell will construct to Fox's specifications. From this transaction, Bell has a \$50,000 credit balance in its account receivable from Fox at December 31, 1985.
- On December 27, 1985, Bell wrote and recorded checks to creditors totaling \$400,000 which would cause an overdraft of \$100,000 in Bell's bank account at December 31, 1985. The checks were mailed out on January 10, 1986.

At December 31, 1985, what amount should Bell report as total current liabilities?

- a. \$1,050,000
- b. \$1,150,000
- c. \$1,400,000
- d. \$1,450,000

1N86#6. Dean, Inc., has \$2,000,000 of notes payable due June 15, 1986. At the financial statement date of December 31, 1985, Dean signed an agreement to borrow up to \$2,000,000 to refinance the notes payable on a long-term basis. The financing agreement called for borrowings not to exceed 80% of the value of the collateral Dean was providing. At the date of issue of the December 31, 1985, financial statements, the value of the collateral was \$2,400,000 and was not expected to fall below this amount during 1986. In its December 31, 1985, balance sheet, Dean should classify notes payable as

	<i>Short-term obligations</i>	<i>Long-term obligations</i>
a.	\$2,000,000	\$0
b.	\$ 400,000	\$1,600,000
c.	\$ 80,000	\$1,920,000
d.	\$0	\$2,000,000

1N86#7. During 1985 Mann Company experienced financial difficulties and is likely to default on a \$500,000, 15%, three-year note dated January 1, 1984, payable to Summit Bank. On December 31, 1985, the bank agreed to settle the note and unpaid interest of \$75,000 for 1985 for \$410,000 cash payable on January 31, 1986. Ignoring income taxes, what amount should Mann report as a gain from the debt restructuring in its 1985 income statement?

- a. \$165,000
- b. \$ 90,000
- c. \$ 75,000
- d. \$0

1N86#8. Included in King Corporation's liability account balances at December 31, 1984, was a note payable in the amount of \$2,400,000. The note is dated

October 1, 1984, bears interest at 15%, and is payable in three equal annual payments of \$800,000. The first interest and principal payment was made on October 1, 1985. In its December 31, 1985, balance sheet, what amount should King report as accrued interest payable for this note?

- a. \$ 60,000
- b. \$ 90,000
- c. \$180,000
- d. \$270,000

1N86#9. For the year ended December 31, 1985, Hurd, Inc., reported book income of \$900,000 before income taxes. Selected information for 1985 is available from Hurd's records as follows:

Interest income on municipal bonds	\$ 70,000
Depreciation claimed on tax return in excess of depreciation per books	130,000
Warranty expense on the accrual basis	60,000
Actual warranty expenditures	35,000

Hurd's income tax rate is 40% for 1985. Hurd's current liability for 1985 income taxes (before reduction for estimated taxes paid) should be

- a. \$280,000
- b. \$290,000
- c. \$332,000
- d. \$360,000

1N86#10. West Company determined that it has an obligation relating to employees' rights to receive compensation for future absences attributable to employees' services already rendered. The obligation relates to rights that vest, and payment of the compensation is probable. The amounts of West's obligations as of December 31, 1985, are reasonably estimated as follows:

Vacation pay	\$110,000
Sick pay	80,000

In its December 31, 1985, balance sheet, what amount should West report as its liability for compensated absences?

- a. \$0
- b. \$ 80,000
- c. \$110,000
- d. \$190,000

1N86#22. The balance in Ott Company's accounts payable account at December 31, 1985, was \$1,100,000 before considering the following information:

- Goods shipped F.O.B. shipping point on December 20, 1985, from a vendor to Ott were lost in transit. The invoice cost of \$20,000 was not recorded by Ott. On January 6, 1986, Ott filed a \$20,000 claim against the common carrier.

Accounting Practice

- On December 27, 1985, a vendor authorized Ott to return, for full credit, goods shipped and billed at \$35,000 on December 2, 1985. The returned goods were shipped by Ott on December 27, 1985. A \$35,000 credit memo was received and recorded by Ott on January 6, 1986.

What amount should Ott report as accounts payable in its December 31, 1985, balance sheet?

- a. \$1,065,000
- b. \$1,085,000
- c. \$1,115,000
- d. \$1,120,000

1M86#23. Dix Company operates a retail store and must determine the proper December 31, 1985, year-end accrual for the following expenses:

- The store lease calls for fixed rent of \$1,200 per month, payable at the beginning of the month, and additional rent equal to 6% of net sales over \$250,000 per calendar year, payable on January 31 of the following year. Net sales for 1985 are \$450,000.
- An electric bill of \$850 covering the period 12/16/85 through 1/15/86 was received January 22, 1986.
- A \$400 telephone bill was received January 7, 1986, covering:

Service in advance for January 1986	\$150
Local and toll calls for December 1985	250

In its December 31, 1985, balance sheet, Dix should report accrued liabilities of

- a. \$15,075
- b. \$13,100
- c. \$12,825
- d. \$12,675

1M86#25. The books of Apex, Inc., for the year ended December 31, 1985, showed income of \$720,000 before provision for income tax. In computing the taxable income for federal income tax purposes, the following differences were taken into account:

Depreciation deducted for tax purposes in excess of depreciation recorded on the books	\$32,000
Income from installment sale reportable for tax purposes in excess of income recognized on the books	24,000

Assuming a corporate income tax rate of 40%, what should Apex record as its current federal income tax liability at December 31, 1985?

- a. \$291,200
- b. \$288,000
- c. \$284,800
- d. \$275,200

1M86#26. Farr Company sells its products in reusable, expensive containers. The customer is charged a deposit for each container delivered and receives a refund for each container returned within two years after the year of delivery. Farr accounts for the containers not returned within the time limit as being retired by sale at the deposit amount. Information for 1985 is as follows:

Containers held by customers at December 31, 1984, from deliveries in:

1983	\$ 75,000	
1984	<u>215,000</u>	\$290,000
Containers delivered in 1985		390,000
Containers returned in 1985 from deliveries in:		

1983	\$ 45,000	
1984	125,000	
1985	<u>143,000</u>	313,000

What amount should Farr report as a liability for returnable containers at December 31, 1985?

- a. \$247,000
- b. \$322,000
- c. \$337,000
- d. \$367,000

2M86#9. Agee Corp. pays its outside salespersons fixed monthly salaries and commissions on net sales. Sales commissions are computed and paid on a monthly basis (in the month following the month of sale), and the fixed salaries are treated as advances against commissions. However, if the fixed salaries for salespersons exceed their sales commissions earned for a month, such excess is not charged back to them. Pertinent data for the month of April 1986 for the three salespersons in sales region 330 are as follows:

Salesperson	Fixed salary	Net sales	Commission rate
A	\$ 5,000	\$100,000	4%
B	7,000	200,000	6%
C	9,000	300,000	6%
Totals	<u>\$21,000</u>	<u>\$600,000</u>	

Selected Questions

For sales region 330, what total amount should Agee accrue for sales commissions payable at April 30, 1986?

- a. \$13,000
- b. \$14,000
- c. \$34,000
- d. \$35,000

1N85#17. Eliot Corporation's liabilities at December 31, 1984, were as follows:

Accounts payable & accrued interest	\$200,000
12% note payable issued November 1, 1984, maturing July 1, 1985	60,000
10% debentures payable, next annual principal installment of \$100,000 due February 1, 1985	700,000

On March 1, 1985, Eliot consummated a noncancellable agreement with the lender to refinance the 12% note payable on a long-term basis, on readily determinable terms that have not yet been implemented. Both parties are financially capable of honoring the agreement, and there have been no violations of any of the agreement's provisions. Eliot's December 31, 1984, financial statements were issued on March 31, 1985.

In its December 31, 1984, balance sheet, Eliot should report current liabilities at

- a. \$200,000
- b. \$260,000
- c. \$300,000
- d. \$360,000

1N85#18. Apex Company employees earn two weeks of paid vacation for each year of employment. Unused vacation time can be accumulated and carried forward to succeeding years, and will be paid at the salary in effect when the vacation is taken. As of December 31, 1984, when Paul's salary was \$600 per week, Paul had earned 18 weeks vacation time and had used 12 weeks of accumulated vacation time. At December 31, 1984, how much should Apex carry as a liability for Paul's accumulated vacation time?

- a. \$0
- b. \$1,200
- c. \$3,600
- d. \$7,200

1N85#25. Eller Company has outstanding at December 31, 1984, several long-term borrowings with annual sinking fund payments and maturities as follows:

	<u>Sinking fund payments</u>	<u>Maturities</u>
1985	\$1,000,000	\$ —
1986	1,000,000	2,500,000
1987	1,000,000	—
1988	1,500,000	3,000,000
1989	1,500,000	3,000,000
1990	2,000,000	3,000,000

Eller appropriately provides footnote disclosures in its 1984 annual report for long-term borrowings which include sinking fund payments and maturities for each of the next five years. The combined aggregate amount for 1989, the fifth year, should be stated as

- a. \$4,500,000
- b. \$5,000,000
- c. \$7,500,000
- d. \$9,500,000

2M85#1. During the year ended December 31, 1984, Pine Co. paid \$46,000 for interest, but Pine's 1984 income statement properly reported interest expense of \$50,000. There was no prepaid interest either at the beginning or at the end of 1984. Accrued interest at December 31, 1984, amounted to \$5,000. How much was the accrued interest at December 31, 1983?

- a. \$0
- b. \$1,000
- c. \$4,000
- d. \$5,000

2M85#2. On January 1, 1984, Oak Co. leased a building to Daly Co. for a ten-year term, at an annual rental of \$100,000. At inception of the lease Oak received \$200,000, covering the first year's rent of \$100,000 and a security deposit of \$100,000. This deposit will not be returned to Daly upon expiration of the lease, but will instead be applied to payment of rent for the last year of the lease. Oak properly reported rental income of \$200,000 in its 1984 income tax return. At December 31, 1984, what portion of the \$200,000 should be shown as a liability in Oak's balance sheet?

- a. \$0
- b. \$ 80,000
- c. \$ 90,000
- d. \$100,000

2M85#7. At December 31, 1984, Reed Corp. owed notes payable of \$1,000,000 with a maturity date of April 30, 1985. These notes did not arise from transactions in the normal course of business. On February 1, 1985, Reed issued \$3,000,000 of ten-year bonds with the intention of using part of the bond proceeds to liquidate the \$1,000,000 of notes payable maturing in April. On March 1, 1985, Reed did in fact liquidate the \$1,000,000 of notes payable, using proceeds from the bond issue. Reed's December 31, 1984, financial statements were issued on March 29, 1985. How much of the \$1,000,000 notes payable should be classified as long-term in Reed's balance sheet at December 31, 1984?

- a. \$0
- b. \$ 100,000
- c. \$ 900,000
- d. \$1,000,000

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B. Deferred Revenues

1M89#34. Dix Company sells magazine subscriptions for one and two year periods. Cash receipts from subscribers are credited to magazine subscriptions collected in advance. This account had a balance of \$2,100,000 at December 31, 1988 before year-end adjustment. Outstanding subscriptions at December 31, 1988 expire as follows:

During 1989	— \$600,000
During 1990	— 900,000

In its December 31, 1988 balance sheet, what amount should Dix report as the balance for magazine subscriptions collected in advance?

- a. \$2,100,000
- b. \$1,500,000
- c. \$1,050,000
- d. \$ 600,000

1M89#39. Rosson Corp., which began business on January 1, 1988, appropriately uses the installment sales method of accounting for income tax reporting purposes. The following data are available for 1988:

Installment accounts receivable, 12/31/88	\$200,000
Installment sales for 1988	\$350,000
Gross profit on sales	40%

Under the installment sales method, what would be Rosson's deferred gross profit at December 31, 1988?

- a. \$120,000
- b. \$ 90,000
- c. \$ 80,000
- d. \$ 60,000

1N88#20. At December 31, 1987, Raft Boutique had 1,000 gift certificates outstanding, which had been sold to customers during 1987 for \$70 each. Raft operates on a gross margin of 60% of its sales. What amount of revenue pertaining to the 1,000 outstanding gift certificates should be deferred at December 31, 1987?

- a. \$0
- b. \$28,000
- c. \$42,000
- d. \$70,000

1N88#21. On December 31, 1987, Parke Corp. sold Edlow Corp. an airplane with an estimated remaining useful life of ten years. At the same time, Parke leased back the airplane for three years. Additional information is as follows:

Sales price	\$600,000
Carrying amount of airplane at date of sale	\$100,000
Monthly rental under lease	\$ 6,330

Interest rate implicit in the lease as computed by Edlow and known by Parke (this rate is lower than the lessee's incremental borrowing rate) 12%
 Present value of operating lease rentals (\$6,330 for 36 months @ 12%) \$190,581
 The leaseback is considered an operating lease

In Parke's December 31, 1987 balance sheet, what amount should be included as deferred revenue on this transaction?

- a. \$0
- b. \$190,581
- c. \$309,419
- d. \$500,000

1M88#31. Hart Company sells subscriptions to a specialized directory that is published semiannually and shipped to subscribers on April 15 and October 15. Subscriptions received after the March 31 and September 30 cutoff dates are held for the next publication. Cash from subscribers is received evenly during the year, and is credited to deferred revenues from subscriptions. Data relating to 1987 are as follows:

Deferred revenues from subscriptions, balance 12/31/86	\$1,500,000
Cash receipts from subscribers	7,200,000

In its December 31, 1987 balance sheet, Hart should report deferred revenues from subscriptions of

- a. \$1,800,000
- b. \$3,300,000
- c. \$3,600,000
- d. \$5,400,000

1M88#32. On December 31, 1987, Ruhl Corp. sold equipment to Dorr and simultaneously leased it back for three years. The following data pertain to the transaction at this date:

Sales price	\$220,000
Carrying amount	150,000
Present value of lease rentals (\$2,000 for 36 months @ 12%)	60,800
Estimated remaining useful life	10 years

At December 31, 1987, what amount should Ruhl report as deferred revenue from the sale of the equipment?

- a. \$0
- b. \$ 9,200
- c. \$60,800
- d. \$70,000

1N87#14. Glen Apparel Shop, Inc. sells gift certificates redeemable only when merchandise is purchased. The certificates have an expiration date two years after

Selected Questions

issuance date. Upon redemption or expiration, Glen recognizes the unearned revenue as realized. Data for 1986 are as follows:

Unearned revenue, 1/1/86	\$ 75,000
Gift certificates sold	250,000
Gift certificates redeemed	205,000
Expired gift certificates	15,000
Cost of goods sold	60%

At December 31, 1986, Glen should report unearned revenue of

- a. \$ 42,000
- b. \$100,000
- c. \$105,000
- d. \$120,000

1N87#15. Ryan, Inc. began operations on January 1, 1986, and appropriately uses the installment method of accounting. The following data are available for 1986:

Installment accounts receivable, 12/31/86	\$ 600,000
Installment sales for 1986	1,050,000
Gross profit on sales	40%

Under the installment method, Ryan's deferred gross profit at December 31, 1986, would be

- a. \$360,000
- b. \$270,000
- c. \$240,000
- d. \$180,000

1N87#18. On December 31, 1986, Lane, Inc. sold equipment to Noll, and simultaneously leased it back for 12 years. Pertinent information at this date is as follows:

Sales price	\$480,000
Carrying amount	360,000
Estimated remaining economic life	15 years

At December 31, 1986, how much should Lane report as deferred revenue from the sale of the equipment?

- a. \$0
- b. \$110,000
- c. \$112,000
- d. \$120,000

1N87#19. Cobb Company sells appliance service contracts agreeing to repair appliances for a two-year period. Cobb's past experience is that, of the total dollars spent for repairs on service contracts, 40% is incurred evenly during the first contract year and 60% evenly during the second contract year. Receipts from service

contract sales for the two years ended December 31, 1986, are as follows:

1985	\$500,000
1986	600,000

Receipts from contracts are credited to unearned service contract revenue. Assume that all contract sales are made evenly during the year. What amount should Cobb report as unearned service contract revenue at December 31, 1986?

- a. \$360,000
- b. \$470,000
- c. \$480,000
- d. \$630,000

1M87#13. Kent Company sells magazine subscriptions for one to three-year periods. Cash receipts from subscribers are credited to magazine subscriptions collected in advance, and this account had a balance of \$2,400,000 at December 31, 1986 before year-end adjustment. Outstanding subscriptions at December 31, 1986, expire as follows:

During 1987	— \$600,000
During 1988	— 900,000
During 1989	— 400,000

In its December 31, 1986 balance sheet, what amount should Kent report as the balance for magazine subscriptions collected in advance?

- a. \$ 500,000
- b. \$1,200,000
- c. \$1,900,000
- d. \$2,400,000

1M87#14. On December 31, 1986, Reed, Inc., authorized Foy to operate as a franchisee for an initial franchise fee of \$75,000. Of this amount, \$30,000 was received upon signing the agreement and the balance, represented by a note, is due in three annual payments of \$15,000 each beginning December 31, 1987. The present value on December 31, 1986, of the three annual payments appropriately discounted is \$36,000. According to the agreement, the nonrefundable down payment represents a fair measure of the services already performed by Reed; however, substantial future services are required of Reed. Collectibility of the note is reasonably certain. On December 31, 1986, Reed should record unearned franchise fees in respect of the Foy franchise of

- a. \$0
- b. \$36,000
- c. \$45,000
- d. \$75,000

1N86#11. Cobb Department Store sells gift certificates redeemable only when merchandise is purchased. These gift certificates have an expiration date of two

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years after issuance date. Upon redemption or expiration, Cobb recognizes the unearned revenue as realized. Information for 1985 is as follows:

Unearned revenue, 1/1/85	\$ 65,000
Gift certificates sold	225,000
Gift certificates redeemed	195,000
Expired gift certificates	10,000
Cost of goods sold	60%

In its December 31, 1985, balance sheet, what amount should Cobb report as unearned revenue?

- a. \$51,000
- b. \$57,000
- c. \$85,000
- d. \$95,000

1N86#12. Beal Company sells contracts agreeing to service equipment for a three-year period. Information for the year ended December 31, 1985, is as follows:

Cash receipts from service contracts sold	\$960,000
Service contract revenue recognized	780,000
Unearned service contract revenue, 1/1/85	570,000

In its December 31, 1985, balance sheet, what amount should Beal report as unearned service contract revenue?

- a. \$390,000
- b. \$510,000
- c. \$640,000
- d. \$750,000

1N86#13. East Company began operations on January 1, 1985, and uses the installment method of accounting for income tax reporting. The following information pertains to East's operations for 1985:

Installment sales	\$800,000
Installment accounts receivable, 12/31/85	500,000
Gross profit on sales	40%

For income tax purposes, East should report deferred gross profit at December 31, 1985, of

- a. \$120,000
- b. \$200,000
- c. \$300,000
- d. \$320,000

1N86#14. On December 31, 1985, Pell, Inc., sold a machine to Flax, and simultaneously leased it back for one year. Pertinent information at this date is as follows:

Sales price	\$360,000
Carrying amount	315,000
Estimated remaining useful life	12 years
Present value of lease rentals (\$3,000 for 12 months @12%)	34,100

At December 31, 1985, how much should Pell report as deferred revenue from the sale of the machine?

- a. \$0
- b. \$10,900
- c. \$34,100
- d. \$45,000

2M86#15. Cone Co., which began operating on January 1, 1985, appropriately uses the installment method of accounting. The following information pertains to Cone's operations for the year 1985:

Installment sales	\$500,000
Cost of installment sales	300,000
General and administrative expenses	50,000
Collections on installment sales	100,000

The balance in the deferred gross profit account at December 31, 1985, should be

- a. \$200,000
- b. \$160,000
- c. \$120,000
- d. \$100,000

1N85#14. Lock Company sells, for cash, appliance service contracts agreeing to service appliances for a one-year, two-year, or three-year period. Cash receipts from contracts are credited to the unearned service contract revenues account which had an unadjusted balance of \$1,580,000 at December 31, 1984. Service contract costs are charged, as incurred, to the service contract expense account which had a balance of \$370,000 at December 31, 1984. Outstanding service contracts at December 31, 1984, expire as follows:

During 1985 —	\$450,000
During 1986 —	350,000
During 1987 —	275,000

At December 31, 1984, how much should Lock report as unearned service contract revenues?

- a. \$ 505,000
- b. \$ 705,000
- c. \$1,075,000
- d. \$1,210,000

1N85#22. Moore Company sells magazine subscriptions for one to three-year periods. The magazine subscriptions collected in advance account had a balance of \$1,800,000 at December 31, 1983. Information for the year 1984 is as follows:

Cash receipts from subscribers	\$2,300,000
Magazine subscriptions revenue	1,600,000

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In its December 31, 1984, balance sheet, how much should Moore report as the balance for magazine subscriptions collected in advance?

- a. \$1,100,000
- b. \$2,100,000
- c. \$2,300,000
- d. \$2,500,000

2M85#10. The following information pertains to equipment sold by Bard Co. to Kerr Co. on December 31, 1984:

Sales price	\$300,000
Book value	100,000
Estimated remaining economic life	20 years

Simultaneously with the sale, Bard leased back the equipment for a period of 16 years. How much of the profit on the sale should Bard defer at December 31, 1984?

- a. \$200,000
- b. \$ 12,500
- c. \$ 10,000
- d. \$0

C. Deferred Income Tax Liabilities

1M89#37. On January 1, 1988, Lum, Inc. purchased a machine for \$90,000 which will be depreciated \$9,000 per year for financial statement reporting. For income tax reporting, Lum elected to expense \$10,000 and to use straight-line depreciation which will allow a cost recovery deduction of \$8,000 for 1988. Lum uses the liability method to account for temporary differences. Assume a present and future enacted income tax rate of 30%. What amount should be added to Lum's deferred income tax liability for this temporary difference at December 31, 1988?

- a. \$5,400
- b. \$3,000
- c. \$2,700
- d. \$2,400

1M89#40. On January 1, 1988, Lundy Corp. purchased 40% of the voting common stock of Glen, Inc. and appropriately accounts for its investment by the equity method. During 1988, Glen reported earnings of \$225,000 and paid dividends of \$75,000. Lundy assumes that all of Glen's undistributed earnings will be distributed as dividends in future periods when the enacted tax rate will be 30%. Ignore the dividend-received deduction. Lundy's current enacted income tax rate is 25%. Lundy uses the liability method to account for temporary differences. The increase in Lundy's deferred income tax liability for this temporary difference is

- a. \$45,000
- b. \$37,500
- c. \$27,000
- d. \$18,000

1M89#41. Lane, Inc., which began operations on January 1, 1986, recognizes income from construction-type contracts under the percentage-of-completion method in its financial statements. Lane appropriately uses the completed contract method for income tax reporting. Reported income from construction-type contracts under each method is as follows:

<u>Year</u>	<u>Percentage-of-completion</u>	<u>Completed contract</u>
1986	\$ 600,000	\$ —
1987	1,200,000	800,000
1988	1,700,000	1,400,000

For all of the above years and years to 1991 the enacted income tax rate is 30%, and there are no other temporary differences. At December 31, 1988, using the liability method, Lane should report a liability for deferred taxes of

- a. \$ 90,000
- b. \$210,000
- c. \$300,000
- d. \$390,000

1M89#42. Among the items reported on Cord, Inc.'s income statement for the year ended December 31, 1988 were the following:

Amortization of goodwill	\$10,000
Insurance premium on life of an officer with Cord as owner and beneficiary	5,000

Temporary differences amount to

- a. \$0
- b. \$ 5,000
- c. \$10,000
- d. \$15,000

D. Capitalized Lease Liability

1M89#44. Beal, Inc. intends to lease a machine from Paul Corp. Beal's incremental borrowing rate is 14%. The prime rate of interest is 8%. Paul's implicit rate in the lease is 10%, which is known to Beal. Beal computes the present value of the minimum lease payments using

- a. 8%
- b. 10%
- c. 12%
- d. 14%

1N88#22. On January 2, 1987, Ashe Company entered into a ten-year noncancelable lease as lessee, requiring annual payments of \$200,000 payable at the beginning of each year. Ashe's incremental borrowing rate is 14%, while the lessor's implicit interest rate, known to Ashe, is 12%. Present value factors of an annuity of 1 in advance for ten periods are 6.33 at 12%,

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and 5.95 at 14%. The leased property has an estimated useful life of 12 years. Ownership of the property remains with the lessor at expiration of the lease. At the inception of the lease, Ashe should record a lease liability of

- \$1,266,000
- \$1,190,000
- \$1,066,000
- \$0

1N88#29. On December 31, 1986, Evan Company leased a machine from Ryan for a ten-year period expiring December 30, 1996. Equal annual payments under the lease are \$100,000 and are due on December 31 of each year. The first payment was made on December 31, 1986, and the second payment was made on December 31, 1987. The present value at December 31, 1986, of the ten lease payments over the lease term discounted at 10% was \$676,000. The lease is appropriately accounted for as a capital lease by Evan. In its December 31, 1987 balance sheet, Evan should report a total lease liability of

- \$800,000
- \$643,600
- \$533,600
- \$518,400

1M88#35. On January 31, 1988, Clay Company leased a new machine from Saxe Corp. The following data relate to the lease transaction at the inception of the lease:

Lease term	10 years
Annual rental payable at beginning of each lease year	\$ 50,000
Useful life of machine	15 years
Implicit interest rate	10%
Present value of an annuity of 1 in advance for 10 periods at 10%	6.76
Present value of annuity of 1 in arrears for 10 periods at 10%	6.15
Fair value of the machine	\$400,000

The lease has no renewal option, and the possession of the machine reverts to Saxe when the lease terminates. At the inception of the lease, Clay should record a lease liability of

- \$400,000
- \$338,000
- \$307,500
- \$0

1M88#36. On December 30, 1986, Drew Co. leased equipment under a capital lease for a period of 10 years. It contracted to pay \$90,000 annual rent on December 31, 1986 and on December 31 of each of the next 9 years. The capital lease liability was appropriately recorded at \$608,400 on December 30, 1986, before the first payment. The leased equipment has a useful life of 12 years and the interest rate implicit in the lease is 10%. Drew uses the straightline method in depreciating

all equipment. In recording the December 31, 1987 payment, Drew should reduce the capital lease liability by

- \$38,160
- \$50,700
- \$51,840
- \$60,840

1N87#23. On December 30, 1986, Frey Company leased equipment from Hull. Pertinent lease transaction data are as follows:

- The estimated seven-year useful equipment life coincides with the lease term.
- The first of the seven equal annual \$200,000 lease payments was paid on December 31, 1986.
- Hull's implicit interest rate of 12% is known to Frey.
- Frey's incremental borrowing rate is 14%.
- Present values of an annuity of 1 in advance for seven periods are 5.11 at 12%, and 4.89 at 14%, respectively.

At inception of the lease, Frey should record a capitalized lease liability of

- \$1,400,000
- \$1,022,000
- \$ 978,000
- \$0

1N87#24. On December 31, 1985, Roe Company leased a machine under a capital lease for a period of ten years, contracting to pay \$100,000 on signing the lease and \$100,000 annually on December 31 of the next nine years. The present value at December 31, 1985, of the ten lease payments over the lease term discounted at 10% was \$676,000. At December 31, 1986, Roe's total capital lease liability is

- \$486,000
- \$518,400
- \$533,600
- \$607,960

1M87#21. On December 31, 1986, Ott Company leased a new machine from Wolf with the following pertinent information:

Lease term	12 years
Annual rental payable at beginning of each year	\$100,000
Useful life of machine	15 years
Implicit interest rate	12%
Present value of an annuity of 1 in advance for 12 periods at 12%	6.94

The lease contains no renewal options and the machine reverts to Wolf at the termination of the lease. The cost of the machine on Wolf's accounting records is \$750,000. At the inception of the lease, Ott should record a lease liability of

- \$0
- \$100,000
- \$694,000
- \$750,000

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1M87#22. Kew Company leased equipment for its entire nine-year useful life, agreeing to pay \$100,000 at the start of the lease term on December 31, 1985, and \$100,000 annually on December 31 of the next eight years. The present value on December 31, 1985, of the nine lease payments over the lease term, discounted at the lessor's implicit rate known by Kew to be 10%, was \$633,000. The December 31, 1985 present value of the lease payments discounted at Kew's incremental borrowing rate of 12% was \$597,000. Kew made a timely second lease payment. The total lease liability at December 31, 1986, was

- a. \$0
- b. \$456,640
- c. \$486,300
- d. \$700,000

1N86#18. On January 2, 1986, Rice Company entered into a ten-year noncancelable lease, as lessee, requiring annual payments of \$100,000 payable at the beginning of each year. Rice's incremental borrowing rate is 14%, while the lessor's implicit interest rate, known to Rice, is 12%. Present value factors of an annuity of 1 in advance for ten periods are 6.33 at 12%, and 5.95 at 14%. The leased property has an estimated useful life of 12 years. Ownership of the property remains with the lessor at expiration of the lease. At the inception of the lease, Rice should record a lease liability of

- a. \$0
- b. \$495,000
- c. \$595,000
- d. \$633,000

1N86#19. On December 31, 1984, Wall Company leased a machine from Ryan for a ten-year period expiring December 30, 1994. Equal annual payments under the lease are \$100,000 and are due on December 31 of each year. The first payment was made on December 31, 1984, and the second payment was made on December 31, 1985. The present value at December 31, 1984, of the ten lease payments over the lease term discounted at 10% was \$676,000. The lease is appropriately accounted for as a capital lease by Wall. In its December 31, 1985, balance sheet Wall should report a lease liability of

- a. \$486,000
- b. \$518,400
- c. \$533,600
- d. \$800,000

1M86#21. Day, Inc., leased a machine for a period of eight years, contracting to pay \$100,000 at inception of the lease term on December 31, 1984, and \$100,000 annually on December 31 of the next seven years. The present value of the eight rent payments over the lease term, appropriately discounted at 10%, was \$587,000. In its December 31, 1985, balance sheet, Day should report a liability under capital lease of

- a. \$600,000
- b. \$545,700
- c. \$438,300
- d. \$435,700

2M86#18. On March 1, 1986, Rory Corp. became the lessee of new equipment under a noncancelable six-year lease. The total estimated economic life of this equipment is ten years. The fair value of this equipment on March 1, 1986, was \$100,000. The related investment tax credit retained by the lessor, and expected to be realized by the lessor, is \$10,000. The lease does not meet the criteria for classification as a capital lease with respect to transfer of ownership of the leased asset, or bargain purchase option, or lease term. Nevertheless, Rory must classify this lease as a capital lease if, at inception of the lease, the present value of the minimum lease payments (excluding executory costs) is equal to at least

- a. \$67,500
- b. \$81,000
- c. \$90,000
- d. \$99,000

1N85#23. On December 31, 1984, Cobb Company leased a new machine from Gill Company. The following data relate to the lease transaction:

- The machine has an estimated useful life of eight years which coincides with the lease term.
- Lease rentals consist of eight equal annual payments of \$100,000, the first of which was paid December 31, 1984.
- Gill's implicit interest rate is 12%, which is known by Cobb.
- Cobb's incremental borrowing rate is 14% at December 31, 1984.
- Present value of an annuity of 1 in advance for eight periods at 12% is 5.56.
- Present value of an annuity of 1 in advance for eight periods at 14% is 5.29.

In its December 31, 1984, balance sheet, Cobb should report a capitalized lease liability of

- a. \$429,000
- b. \$456,000
- c. \$529,000
- d. \$556,000

E. Bonds Payable

1M89#45. On April 1, 1988, Fox, Inc. issued 400 of its 10%, \$1,000 bonds at 97 plus accrued interest. The bonds are dated January 1, 1988 and mature on January 1, 1998. Interest is payable semiannually on January 1 and July 1. What amount of cash would Fox receive from the bond issuance?

- a. \$378,000
- b. \$388,000
- c. \$393,000
- d. \$398,000

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1M89#46. On July 1, 1987, Cobb, Inc. issued 9% bonds in the face amount of \$1,000,000, which mature on July 1, 1997. The bonds were issued for \$939,000 to yield 10%, resulting in a bond discount of \$61,000. Cobb uses the interest method of amortizing bond discount. Interest is payable annually on June 30. At June 30, 1989, Cobb's unamortized bond discount should be

- \$52,810
- \$51,000
- \$48,800
- \$43,000

1M89#47. On June 30, 1988, Eddy Corp. had outstanding 8%, \$2,000,000 face amount convertible bonds maturing on June 30, 1998. Interest is payable on June 30 and December 31. Each \$1,000 bond is convertible into 40 shares of Eddy's \$20 par common stock. After amortization through June 30, 1988, the unamortized balance in the premium on bonds payable account was \$50,000. On June 30, 1988, 1,000 bonds were converted when Eddy's common stock had a market price of \$30 per share. Under the book value method, what amount should Eddy credit to additional paid-in capital in recording the conversion?

- \$425,000
- \$400,000
- \$225,000
- \$200,000

1M89#49. On July 1, 1982, Flax Corporation issued 2,000 of its 9%, \$1,000 callable bonds for \$1,920,000. The bonds are dated July 1, 1982 and mature on July 1, 1992. Interest is payable semiannually on January 1 and July 1. Flax uses the straight-line method of amortizing bond discount. The bonds can be called by the issuer at 101 at any time after June 30, 1987.

On July 1, 1988, Flax called in all of the bonds and retired them. Before income taxes, how much loss should Flax report on this early extinguishment of debt for the year ended December 31, 1988?

- \$ 20,000
- \$ 52,000
- \$ 68,000
- \$100,000

1N88#32. On March 1, 1988, Case Corp. issued \$1,000,000 of 10% nonconvertible bonds at 103, due on February 28, 1998. Each \$1,000 bond was issued with 30 detachable stock warrants, each of which entitled the holder to purchase, for \$50, one share of Case common stock, par value \$25. On March 1, 1988, the quoted market value of each warrant was \$4. What amount of the bond issue proceeds should Case record as an increase in stockholders' equity?

- \$120,000
- \$ 90,000
- \$ 30,000
- \$0

1N88#39. Ray Corp. has \$300,000 convertible 8% bonds outstanding at June 30, 1988. Each \$1,000 bond is convertible into 10 shares of Ray's \$50 par value

common stock. On July 1, 1988, the interest was paid to bondholders, and the bonds were converted into common stock which had a fair market value of \$75 per share. The unamortized premium on these bonds payable is \$6,000 at the date of conversion. Under the book value method, this conversion increases the following elements of the stockholders' equity section by

	<u>Common stock</u>	<u>Additional paid-in capital</u>
a.	\$300,000	\$ 6,000
b.	\$225,000	\$ 81,000
c.	\$153,000	\$153,000
d.	\$150,000	\$156,000

1M88#37. On April 1, 1988, Greg Corp. issued, at 99 plus accrued interest, 200 of its 8%, \$1,000 bonds. The bonds are dated January 1, 1988, mature on January 1, 1998, and pay interest on July 1 and January 1. Greg paid bond issue costs of \$7,000. From the bond issuance, Greg received net cash of

- \$202,000
- \$198,000
- \$195,000
- \$191,000

1M88#38. On April 30, 1988, Witt Corp. had outstanding 8%, \$1,000,000 face amount, convertible bonds maturing on April 30, 1992. Interest is payable on April 30 and October 31. On April 30, 1988, all these bonds were converted into 40,000 shares of \$20 par common stock. On the date of conversion:

- Unamortized bond discount was \$30,000.
- Each bond had a market price of \$1,080.
- Each share of stock had a market price of \$28.

Under the book value method, what amount should Witt record as a loss on conversion of bonds?

- \$150,000
- \$110,000
- \$ 30,000
- \$0

1M88#39. On May 1, 1988, Hill Corp. issued \$2,000,000, 20-year, 10% bonds for \$2,120,000. Each \$1,000 bond had a detachable warrant eligible for the purchase of one share of Hill's \$50 par common stock for \$60. Immediately after bonds were issued, Hill's securities had the following market values:

10% bond without warrant	\$1,040
Warrant	20
Common stock, \$50 par	56

What amount should Hill credit to premium on bonds payable?

- \$120,000
- \$ 80,000
- \$ 40,000
- \$0

Selected Questions

1N87#25. On June 30, 1987, Town, Inc. had outstanding 10%, \$1,000,000 face amount, 15-year bonds maturing on June 30, 1995. Interest is paid on June 30 and December 31, and bond discount and bond issue costs are amortized on these dates. The unamortized balances on June 30, 1987, of bond discount and bond issue costs were \$55,000 and \$20,000, respectively. Town reacquired all of these bonds at 96 on June 30, 1987, and retired them. Ignoring income taxes, how much gain or loss should Town record on the bond retirement?

- a. Loss of \$15,000.
- b. Loss of \$35,000.
- c. Gain of \$ 5,000.
- d. Gain of \$40,000.

1N87#26. On January 1, 1987, Colt Company issued ten-year bonds with a face amount of \$1,000,000 and a stated interest rate of 8% payable annually on January 1. The bonds were priced to yield 10%. Present value factors are as follows:

	<u>At 8%</u>	<u>At 10%</u>
Present value of 1 for 10 periods	0.463	0.386
Present value of an ordinary annuity of 1 for 10 periods	6.710	6.145

The total issue price (rounded) of the bonds was

- a. \$1,000,000
- b. \$ 980,000
- c. \$ 920,000
- d. \$ 880,000

1N87#27. During 1986 Cain Corporation incurred the following costs in connection with the issuance of bonds:

Printing and engraving	\$ 15,000
Legal fees	80,000
Fees paid to independent accountants for registration information	10,000
Commissions paid to underwriter	150,000

What amount should be recorded as a deferred charge to be amortized over the term of the bonds?

- a. \$ 15,000
- b. \$150,000
- c. \$245,000
- d. \$255,000

1N87#28. On January 1, 1987, Wolf, Inc. issued its 10% bonds in the face amount of \$500,000, that mature on January 1, 1997. The bonds were issued for \$443,000 to yield 12%, resulting in bond discount of \$57,000. Wolf uses the interest method of amortizing bond discount. Interest is payable July 1 and January 1. For the six months ended June 30, 1987, Wolf should report bond interest expense at

- a. \$25,000
- b. \$26,580
- c. \$27,850
- d. \$28,420

1N87#29. Ward, Inc. had outstanding 10%, \$1,000,000 face amount convertible bonds maturing on December 31, 1991, on which interest is paid December 31 and June 30. After amortization through June 30, 1987, the unamortized balance in the bond premium account was \$30,000. On that date, bonds with a face amount of \$500,000 were converted into 20,000 shares of \$20 par common stock. Ward incurred expenses of \$10,000 in connection with the conversion. Recording the conversion by the book value (carrying amount) method, Ward should credit additional paid-in capital for

- a. \$120,000
- b. \$115,000
- c. \$105,000
- d. \$100,000

1M87#25. Glen Corporation had the following long-term debt:

Sinking fund bonds, maturing in installments	\$1,100,000
Industrial revenue bonds, maturing in installments	900,000
Subordinated bonds, maturing on a single date	1,500,000

The total of the serial bonds amounted to

- a. \$1,500,000
- b. \$2,000,000
- c. \$2,400,000
- d. \$3,500,000

1M87#26. On October 1, 1986, Dix, Inc., issued at 101 plus accrued interest, 400 of its 10%, \$1,000 bonds. The bonds are dated July 1, 1986, and mature on July 1, 1996. Interest is payable semiannually on January 1 and July 1. At the time of issuance, Dix would receive cash of

- a. \$394,000
- b. \$404,000
- c. \$410,000
- d. \$414,000

1M87#27. On July 1, 1986, Lundy Company issued for \$438,000, five hundred of its 8%, \$1,000 bonds. The bonds were issued to yield 10%. The bonds are dated July 1, 1986, and mature on July 1, 1996. Interest is payable semiannually on January 1 and July 1. Using the interest method, how much of the bond discount should be amortized for the six months ended December 31, 1986?

- a. \$3,800
- b. \$3,100
- c. \$2,480
- d. \$1,900

1M87#28. On June 30, 1986, Frey Corp. had outstanding 8%, \$2,000,000 face amount convertible bonds maturing on June 30, 1991. Interest is payable on June 30 and December 31. Each \$1,000 bond is convertible into

Accounting Practice

40 shares of Frey's \$20 par common stock. After amortization through June 30, 1986, the unamortized balance in the premium on bonds payable account was \$50,000. On June 30, 1986, 1,000 bonds were converted when Frey's common stock had a market price of \$30 per share. Using the book value method, what amount should Frey credit to additional paid-in capital in recording the conversion?

- a. \$200,000
- b. \$225,000
- c. \$250,000
- d. \$400,000

1M87#37. On April 1, 1987, Lane Corporation issued \$1,500,000 of 10% nonconvertible bonds at 104 which are due on March 31, 1999. Each \$1,000 bond was issued with 40 detachable stock warrants, each of which entitled the bondholder to purchase, for \$50, one share of Lane common stock, \$25 par. On April 1, 1987, the market value of Lane's common stock was \$40 per share and the market value of each warrant was \$4. What amount of the proceeds from the bond issue should Lane record as an increase in stockholders' equity?

- a. \$1,500,000
- b. \$ 240,000
- c. \$ 60,000
- d. \$0

1M87#38. On February 1, 1984, Dax Corp. issued 12%, \$2,000,000 face amount, 10-year bonds for \$2,234,000 plus accrued interest. The bonds are dated November 1, 1983, and interest is payable on May 1 and November 1. Dax reacquired all of these bonds at 102 on May 1, 1987, and retired them. Unamortized bond premium on that date was \$156,000. Ignoring the income tax effect, what was Dax's gain on the bond retirement?

- a. \$116,000
- b. \$194,000
- c. \$234,000
- d. \$236,000

1N86#15. On January 1, 1985, Ward Corp. issued its 9% bonds in the face amount of \$2,000,000, which mature on January 1, 1995. The bonds were issued for \$1,878,000 to yield 10%, resulting in bond discount of \$122,000. Ward uses the interest method of amortizing bond discount. Interest is payable annually on December 31. At December 31, 1985, Ward's unamortized bond discount should be

- a. \$114,200
- b. \$104,000
- c. \$103,220
- d. \$102,000

1N86#20. On July 1, 1986, Carr, Inc., issued at 104, one thousand of its 10%, \$1,000 bonds. The bonds were issued through an underwriter to whom Carr paid bond

issue costs of \$25,000. On July 1, 1986, Carr should report the bond liability at

- a. \$ 975,000
- b. \$1,015,000
- c. \$1,040,000
- d. \$1,065,000

1N86#21. On January 1, 1979, Case, Inc., issued for \$970,000, one thousand of its 9%, \$1,000 callable bonds. The bonds mature on December 31, 1993, and interest is payable on January 1 and July 1. The bonds can be called by Case at 101 on any interest payment date after December 31, 1984. The unamortized bond discount was \$16,000 at December 31, 1985, and the market price of the bonds was 98 on this date. In its December 31, 1985, balance sheet, Case should report the carrying amount of the bonds at

- a. \$ 980,000
- b. \$ 984,000
- c. \$ 986,000
- d. \$1,010,000

1N86#22. On June 30, 1986, Frey Company had outstanding 8%, \$1,000,000 face amount, 15-year bonds maturing on June 30, 1993. Interest is payable on June 30 and December 31. The unamortized balances on June 30, 1986, in the bond discount and deferred bond issue costs accounts were \$35,000 and \$10,000, respectively. Frey acquired all of these bonds at 94 on June 30, 1986, and retired them. Ignoring income taxes, how much gain should Frey report on this early extinguishment of debt?

- a. \$15,000
- b. \$25,000
- c. \$35,000
- d. \$60,000

1N86#31. On December 31, 1985, Cey, Inc., had outstanding 10%, \$1,000,000 face amount convertible bonds maturing on December 31, 1990. Interest is payable on June 30 and December 31. Each \$1,000 bond is convertible into 50 shares of Cey's \$10 par common stock. On December 31, 1985, the unamortized balance in the premium on bonds payable account was \$60,000. On December 31, 1985, 400 bonds were converted when Cey's common stock had a market price of \$24 per share. Using the book value method, Cey's entry to record the conversion should include a credit to additional paid-in capital of

- a. \$176,000
- b. \$224,000
- c. \$260,000
- d. \$280,000

1M86#37. Wolf Company issued 1,000 of its \$1,000 face amount, 20-year bonds on June 30, 1985, for \$1,020,000. Each bond carries five detachable stock purchase warrants, each of which entitles the holder to

Selected Questions

purchase for \$60 one share of Wolf's common stock. On June 30, 1985, the market prices were \$50 per share of Wolf's common stock and \$5 per warrant. In its June 30, 1985, balance sheet, at what amount should Wolf report the carrying amount of the bonds?

- a. \$ 995,000
- b. \$1,000,000
- c. \$1,020,000
- d. \$1,045,000

2M86#8. Zola Corp. had the following long-term debt:

Bonds maturing in installments, secured by machinery	\$ 500,000
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Bonds maturing on a single date, secured by realty	900,000
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Collateral trust bonds	1,000,000
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The debenture bonds amounted to

- a. \$0
- b. \$ 500,000
- c. \$ 900,000
- d. \$1,000,000

2M86#17. On January 1, 1985, when the market rate for bond interest was 12%, Ajax Corp. issued \$1,000,000 face amount of bonds, with interest to be paid semiannually at a 10% annual rate. The bonds mature on December 31, 1994, and were issued at a discount of \$114,500. How much of the discount should be amortized by the interest method at July 1, 1985?

- a. \$1,145
- b. \$3,130
- c. \$5,725
- d. \$6,870

2M86#20. On January 1, 1985, Okon Corp. issued 1,000 of its 9%, \$1,000 bonds, at 95. Interest is payable semiannually on July 1 and January 1. The bonds mature on January 1, 1995. Okon paid bond issue costs of \$40,000, which are appropriately recorded as a deferred charge. Okon uses the straight-line method of amortizing bond discount and bond issue costs. On Okon's December 31, 1985, balance sheet, how much would be shown as the carrying amount of the bonds payable?

- a. \$ 919,000
- b. \$ 955,000
- c. \$ 991,000
- d. \$1,045,000

1N85#21. On January 1, 1985, Dean Company issued ten-year bonds with a face value of \$1,000,000 and a stated interest rate of 8% per year payable semi-

annually July 1 and January 1. The bonds were sold to yield 10%. Present value factors are as follows:

Present value of 1 for 10 periods at 10%	.386
Present value of 1 for 20 periods at 5%	.377
Present value of an annuity of 1 for 10 periods at 10%	6.145
Present value of an annuity of 1 for 20 periods at 5%	12.462

The total issue price of the bonds is

- a. \$ 875,480
- b. \$ 877,600
- c. \$ 980,000
- d. \$1,000,000

1N85#24. On January 1, 1985, Carr, Inc., issued its 10% bonds in the face amount of \$400,000, which mature on January 1, 1995. The bonds were issued for \$354,000 to yield 12%, resulting in a bond discount of \$46,000. Carr uses the interest method of amortizing bond discount. Interest is payable semiannually on July 1 and January 1. For the six months ended June 30, 1985, Carr should report bond interest expense at

- a. \$24,000
- b. \$22,300
- c. \$21,240
- d. \$20,000

1N85#31. Burg, Inc., issued \$500,000 face amount of 10% bonds with interest payable on January 1 and July 1. The bonds were called in at 103 on July 1, 1985, and retired. Unamortized bond discount amounted to \$40,000 at July 1, 1985. Burg's income tax rate is 40% for 1985. How much loss should Burg report on this early extinguishment of debt?

- a. \$15,000
- b. \$22,000
- c. \$33,000
- d. \$55,000

2M85#4. Kork Corp. had the following long-term debt at December 31, 1984:

Collateral trust bonds, having securities of unrelated corporations as security	\$500,000
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Bonds unsecured as to principal	300,000
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The debenture bonds amounted to

- a. \$0
- b. \$300,000
- c. \$500,000
- d. \$800,000

Accounting Practice

2M85#5. The following costs were incurred in connection with the issuance of bonds by Hub Corp.:

Printing and engraving	\$ 5,000
Legal and accounting	100,000
Commissions	180,000

How much should be treated as a deferred charge to be amortized over the life of the debt?

- \$ 5,000
- \$100,000
- \$280,000
- \$285,000

F. Contingent Liabilities and Commitments

1M89#43. On December 31, 1988, Mith Co. was a defendant in a pending lawsuit. The suit arose from the alleged defect of a product that Mith sold in 1986. In the opinion of Mith's attorney, it is probable that Mith will have to pay \$50,000, and it is reasonably possible that Mith will have to pay \$60,000 as a result of this lawsuit. In its 1988 financial statements, Mith would report

- An accrued liability of \$50,000 only.
- An accrued liability of \$50,000 and would disclose a contingent liability of an additional \$10,000.
- An accrued liability of \$60,000 only.
- No information about this lawsuit.

1N88#25. In packages of its products, the Kent Food Company includes coupons which may be presented to grocers for discounts on certain products of Kent on or before a stated expiration date. The grocers are reimbursed when they send the coupons to Kent. In Kent's experience, 40% of such coupons are redeemed, and one month generally elapses between the date a grocer receives a coupon from a consumer and the date Kent receives it. During 1987, Kent issued two series of coupons as follows:

<u>Issued of</u>	<u>Total value</u>	<u>Consumer expiration date</u>	<u>Amount disbursed as of 12/31/87</u>
1/1/87	\$100,000	6/30/87	\$34,000
7/1/87	120,000	12/31/87	40,000

Kent's December 31, 1987 balance sheet should include a liability for unredeemed coupons of

- \$0
- \$ 8,000
- \$14,000
- \$48,000

1N88#30. During 1986, Ward Company introduced a new product carrying a two-year warranty against defects. The estimated warranty costs related to dollar sales are 2% within 12 months following sale and 4%

in the second 12 months following sale. Sales and actual warranty expenditures for the years ended December 31, 1986 and 1987, are as follows:

	<u>Sales</u>	<u>Actual warranty expenditures</u>
1986	\$300,000	\$ 4,500
1987	500,000	15,000
	<u>\$800,000</u>	<u>\$19,500</u>

At December 31, 1987, Ward would report an estimated warranty liability of

- \$28,500
- \$22,500
- \$ 8,500
- \$ 5,000

1M88#40. Dix Company includes in packages of its products coupons that may be presented at retail stores to obtain discounts on other Dix products. Retailers are reimbursed for the face amount of coupons redeemed plus 10% of that amount for handling costs. Dix honors requests for coupon redemption by retailers up to three months after the consumer expiration date. Dix estimates that 70% of all coupons issued will ultimately be redeemed. Information relating to coupons issued by Dix during 1987 is as follows:

Consumer expiration date	12/31/87
Total face amount of coupons issued	\$300,000
Total payments to retailers as of 12/31/87	110,000

What amount should Dix report as a liability for unredeemed coupons at December 31, 1987?

- \$154,000
- \$121,000
- \$100,000
- \$0

1M88#41. On December 31, 1987, Beal Company was involved in a tax dispute with the IRS. Beal's tax counsel believed that an unfavorable outcome was probable and a reasonable estimate of additional taxes was \$550,000, with a chance that the additional taxes could be as much as \$850,000. After the 1987 financial statements were issued, Beal accepted an IRS settlement offer of \$650,000. What amount of additional taxes should have been charged to income in 1987?

- \$850,000
- \$650,000
- \$550,000
- \$0

1N87#31. Kent Corp. carries \$10,000,000 comprehensive public liability insurance with a \$200,000 deductible clause. A suit for personal injury damages was brought against Kent in 1986. Kent's counsel believes it prob-

Selected Questions

able that the insurance company will settle out of court for an estimated amount of \$350,000. At December 31, 1986, Kent should report an accrued liability of

- a. \$350,000
- b. \$200,000
- c. \$150,000
- d. \$0

1M87#35. On November 5, 1986, a Dunn Corp. truck was in an accident with an auto driven by Bell. Dunn received notice on January 12, 1987, of a lawsuit for \$700,000 damages for personal injuries suffered by Bell. Dunn Corp.'s counsel believes it is probable that Bell will be awarded an estimated amount in the range between \$200,000 and \$450,000, and that \$300,000 is a better estimate of potential liability than any other amount. Dunn's accounting year ends on December 31, and the 1986 financial statements were issued on March 2, 1987. What amount of loss should Dunn accrue at December 31, 1986?

- a. \$0
- b. \$200,000
- c. \$300,000
- d. \$450,000

1M87#29. On January 17, 1987, an explosion occurred at a Cord Company plant causing extensive property damage to area buildings. Although no claims had yet been asserted against Cord by March 10, 1987, Cord's management and counsel concluded that it is reasonably possible Cord will be responsible for damages, and that \$2,500,000 would be a reasonable estimate of its liability. Cord's \$10,000,000 comprehensive public liability policy has a \$500,000 deductible clause. In Cord's December 31, 1986 financial statements, which were issued on March 25, 1987, how should this item be reported?

- a. No footnote disclosure or accrual is necessary.
- b. As a footnote disclosure indicating the possible loss of \$500,000.
- c. As an accrued liability of \$500,000.
- d. As a footnote disclosure indicating the possible loss of \$2,500,000.

1M87#30. During 1986 Beal Company became involved in a tax dispute with the IRS. At December 31, 1986, Beal's tax advisor believed that an unfavorable outcome was probable and a reasonable estimate of additional taxes was \$500,000, but could be as much as \$650,000. After the 1986 financial statements were issued, Beal received and accepted an IRS settlement offer of \$550,000. What amount of accrued liability would Beal have reported in its December 31, 1986 balance sheet?

- a. \$650,000
- b. \$550,000
- c. \$500,000
- d. \$0

1N86#23. Mill Company sells washing machines that carry a three-year warranty against manufacturer's defects. Based on company experience, warranty costs are estimated at \$30 per machine. During 1985 Mill sold 24,000 washing machines and paid warranty costs of \$170,000. In its income statement for the year ended December 31, 1985, Mill should report warranty expense of

- a. \$170,000
- b. \$240,000
- c. \$550,000
- d. \$720,000

1N86#24. During 1985 Day Company sold 500,000 boxes of cake mix under a new sales promotional program. Each box contains one coupon, which submitted with \$4.00, entitles the customer to a baking pan. Day pays \$5.00 per pan and \$.50 for handling and shipping. Day estimates that 80% of the coupons will be redeemed, even though only 300,000 coupons had been processed during 1985. What amount should Day report as a liability for unredeemed coupons at December 31, 1985?

- a. \$100,000
- b. \$150,000
- c. \$300,000
- d. \$500,000

1M86#29. Dunn Trading Stamp Company records stamp service revenue and provides for the cost of redemptions in the year stamps are sold to licensees. Dunn's past experience indicates that only 80% of the stamps sold to licensees will be redeemed. Dunn's liability for stamp redemptions was \$12,000,000 at December 31, 1984. Additional information for 1985 is as follows:

Stamp service revenue from stamps sold to licensees	\$8,000,000
Cost of redemptions (stamps sold prior to 1/1/85)	5,500,000

If all the stamps sold in 1985 were presented for redemption in 1986, the redemption cost would be \$4,500,000. What amount should Dunn report as a liability for stamp redemptions at December 31, 1985?

- a. \$ 6,500,000
- b. \$10,100,000
- c. \$11,000,000
- d. \$14,500,000

2M86#7. The following information pertains to a fire insurance policy in effect during the calendar year 1985, covering Vail Co.'s inventory:

Face amount of policy	\$800,000
Deductible clause	50,000
Amount of premium	4,000
Coinurance clause	80%

Vail's inventory averages \$1,000,000 uniformly throughout the year. Vail's income tax rate is 40%.

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How much of a contingent liability should Vail accrue at December 31, 1985, to cover possible future fire losses?

- a. \$0
- b. \$ 30,000
- c. \$ 46,000
- d. \$120,000

1N85#20. During 1983 Dall Company introduced a new product carrying a two-year warranty against defects. The estimated warranty costs related to dollar sales are 2% within 12 months following sale and 4% in the second 12 months following sale. Sales and actual warranty expenditures for the years ended December 31, 1983 and 1984, are as follows:

	<u>Sales</u>	<u>Actual warranty expenditures</u>
1983	\$300,000	\$ 4,500
1984	500,000	15,000
	<u>\$800,000</u>	<u>\$19,500</u>

On December 31, 1984, Dall should report an estimated warranty liability of

- a. \$28,500
- b. \$22,500
- c. \$ 5,000
- d. \$0

2M85#3. On July 1, 1984, Dale Co. started a sales promotional campaign. In each box of cereal sold, Dale inserted a coupon redeemable for a premium. To receive a premium, each customer must submit five coupons. Dale's cost for each premium is \$1. Dale estimated that 60% of the coupons issued will be redeemed. For the six months ended December 31, 1984, the following information is available:

Boxes of cereal sold	800,000
Coupons redeemed	200,000

The estimated liability for premium claims outstanding at December 31, 1984, should be

- a. \$40,000
- b. \$56,000
- c. \$72,000
- d. \$96,000

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

A. Preferred and Common Stock

1N88#48. At December 31, 1987, Tara Corp.'s stockholders' equity consisted of the following:

Preferred stock, \$100 par, 10% noncumulative; 10,000 shares authorized, issued, and outstanding	\$1,000,000
Common stock, \$20 par; 100,000 shares authorized; 80,000 shares issued and outstanding	1,600,000
Retained earnings	600,000

The preferred stock has a liquidating value of \$110 a share. At December 31, 1987, the book value per share of common stock is

- a. \$20.00
- b. \$22.00
- c. \$26.25
- d. \$27.50

1M88#42. Park Corp.'s stockholders' equity accounts at December 31, 1987 were as follows:

Common stock, \$20 par	\$8,000,000
Additional paid-in capital	2,550,000
Retained earnings	1,275,000

All shares of common stock outstanding at December 31, 1987 were issued in 1984 for \$26 a share. On January 4, 1988, Park reacquired 20,000 shares of its common stock at \$24 a share and retired them. Immediately after the shares were retired, the balance in additional paid-in capital would be

- a. \$2,430,000
- b. \$2,470,000
- c. \$2,510,000
- d. \$2,590,000

1N86#25. On July 1, 1986, Hart Corporation issued 1,000 shares of its \$10 par common and 2,000 shares of its \$10 par convertible preferred stock for a lump sum of \$40,000. At this date Hart's common stock was selling for \$18 per share and the convertible preferred stock for \$13.50 per share. The amount of proceeds allocated to Hart's preferred stock should be

- a. \$22,000
- b. \$24,000
- c. \$27,000
- d. \$30,000

1N86#26. The stockholders' equity section of Kern Corporation's balance sheet at December 31, 1985, was as follows:

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Common stock, \$10 par; authorized 1,000,000 shares; issued and outstanding 900,000 shares	\$ 9,000,000
Additional paid-in capital	2,700,000
Retained earnings	1,300,000
Total stockholders' equity	<u>\$13,000,000</u>

All outstanding shares of common stock were issued in 1983 for \$13 per share. On January 2, 1986, Kern acquired 100,000 shares of its stock at \$12 per share and retired them. Immediately after retirement of the shares, the balance in additional paid-in capital should be

- a. \$2,800,000
- b. \$2,600,000
- c. \$2,500,000
- d. \$2,400,000

1N86#28. Dix Corporation's stockholders' equity at December 31, 1985, consisted of the following:

8% cumulative preferred stock, \$50 par; liquidating value \$55 per share; authorized, issued and outstanding 20,000 shares	\$1,000,000
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Common stock, \$25 par; 200,000 shares authorized; 100,000 shares issued and outstanding	2,500,000
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Retained earnings	400,000
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Dividends on preferred stock have been paid through 1984 but have not been declared for 1985. At December 31, 1985, Dix's book value (equity) per common share was

- a. \$25.00
- b. \$27.20
- c. \$28.20
- d. \$29.00

2N85

Items 12 through 16* are based on the following data:

Beef Corporation STOCKHOLDERS' EQUITY December 31, 1983

Common stock, \$1 par value; authorized 3,000,000 shares; issued 1,500,000 shares; outstanding 1,400,000 shares	\$ 1,400,000
Additional paid-in capital:	
In excess of par	14,000,000
From treasury stock	200,000
Total paid-in capital	15,600,000
Unappropriated retained earnings	8,100,000
Total stockholders' equity	<u>\$23,700,000</u>

*The items omitted can be found in other Content Specification Groups.

All of the outstanding common stock and treasury stock were originally issued in 1981 for \$11.00 per share. The treasury stock is common stock reacquired on March 31, 1983. Beef uses the par value method of accounting for treasury stock.

During 1984 the following events or transactions occurred relating to Beef's stockholders' equity:

- February 12, 1984 — Issued 400,000 shares of unissued common stock for \$12.50 per share.
- June 15, 1984 — Declared a cash dividend of \$0.20 per share to stockholders of record on April 1, 1984, and payable on April 15, 1984. This was the first dividend ever declared by Beef.
- September 20, 1984 — Beef's president retired. Beef purchased from the retiring president 100,000 shares of Beef's common stock for \$13.00 per share, which was equal to market value on this date. This stock was cancelled.
- December 15, 1984 — Declared a cash dividend of \$0.20 per share to stockholders of record on January 2, 1985, and payable on January 15, 1985.
- At December 31, 1984, Beef is being sued by two separate parties for patent infringements. Beef's management and outside legal counsel share the following opinions regarding these suits:

<i>Suit</i>	<i>Likelihood of losing the suit</i>	<i>Estimated loss</i>
#1	Reasonably possible	\$600,000
#2	Probable	400,000

12. The issuance of 400,000 shares of common stock on February 12, 1984, caused Beef's additional paid-in capital in excess of par to increase by

- a. \$0
- b. \$ 400,000
- c. \$4,600,000
- d. \$5,000,000

13. The retirement of 100,000 shares of common stock on September 20, 1984, caused Beef's additional paid-in capital in excess of par to decrease by

- a. \$0
- b. \$ 100,000
- c. \$1,000,000
- d. \$1,200,000

1M85

Items 14 and 15 are based on the following data:

Frey, Inc., was organized on January 2, 1984, with the following capital structure:

10% cumulative preferred stock, par value \$100 and liquidation value \$105; authorized, issued and outstanding 1,000 shares	\$100,000
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Accounting Practice

Common stock, par value \$25; authorized 100,000 shares; issued and outstanding 10,000 shares \$250,000

Frey's net income for the year ended December 31, 1984, was \$450,000, but no dividends were declared.

14. How much was Frey's book value per preferred share at December 31, 1984?

- a. \$100
- b. \$105
- c. \$110
- d. \$115

15. How much was Frey's book value per common share at December 31, 1984?

- a. \$45.00
- b. \$68.50
- c. \$69.50
- d. \$70.00

B. Additional Paid-in Capital

1N88#28. Ashe Corp. was organized on January 1, 1987, with authorized capital of 100,000 shares of \$20 par value common stock. During 1987 Ashe had the following transactions affecting stockholders' equity:

January 10 — Issued 25,000 shares at \$22 a share.
March 25 — Issued 1,000 shares for legal services when the fair value was \$24 a share.
September 30 — Issued 5,000 shares for a tract of land when the fair value was \$26 a share.

What amount should Ashe report for additional paid-in capital at December 31, 1987?

- a. \$84,000
- b. \$80,000
- c. \$54,000
- d. \$50,000

1N86#27. On October 1, 1986, Ames Company issued 2,000 shares of its \$10 par common stock to Clark for a tract of land. The stock had a fair market value of \$18 per share on this date. On Clark's last property tax bill the land was assessed at \$24,000. Ames should record an increase in additional paid-in capital of

- a. \$0
- b. \$ 4,000
- c. \$10,000
- d. \$16,000

1M85#16. Landy Corporation was organized on January 2, 1984, with authorized capital of 100,000 shares of \$10 par value common stock. During 1984, Landy had the following transactions:

January 12 — Issued 20,000 shares at \$12 per share
April 23 — Issued 1,000 shares for legal services when the market price was \$14 per share

What should be the amount of additional paid-in capital at December 31, 1984?

- a. \$ 4,000
- b. \$14,000
- c. \$40,000
- d. \$44,000

C. Retained Earnings and Dividends

2M89#2. Lind Corp. declared a cash dividend of \$50,000 on March 10, 1989 to stockholders of record March 25, 1989, payable on April 5, 1989. As a result of this cash dividend, working capital

- a. Decreased on March 10 by \$50,000.
- b. Decreased on March 25 by \$50,000.
- c. Decreased on April 5 by \$50,000.
- d. Did not change.

2M89#3. On May 1, 1989, Rhud Corp. declared and issued a 10% common stock dividend. Prior to this dividend, Rhud had 100,000 shares of \$1 par value common stock issued and outstanding. The fair value of Rhud's common stock was \$30 per share on May 1, 1989. As a result of this stock dividend, Rhud's total stockholders' equity

- a. Increased by \$300,000.
- b. Decreased by \$300,000.
- c. Decreased by \$10,000.
- d. Did not change.

1N88#60. Bain Corp. owned 20,000 common shares of Tell Corp. purchased in 1983 for \$180,000. On December 15, 1987, Bain declared a property dividend of all of its Tell Corp. shares on the basis of one share of Tell for every 10 shares of Bain common stock held by its stockholders. The property dividend was distributed on January 15, 1988. On the declaration date, the aggregate market price of the Tell shares held by Bain was \$300,000. The entry to record the declaration of the dividend would include a debit to retained earnings (or property dividends declared) of

- a. \$0
- b. \$120,000
- c. \$180,000
- d. \$300,000

1M88#43. On January 5, 1988, Sardi Minerals Corp. declared a cash dividend of \$600,000 to stockholders of record on January 21, 1988, and payable on February 11, 1988. The dividend is permissible under the laws of Sardi's state of incorporation. The following data pertain to 1987:

Net income for year ended 12/31/87	\$190,000
Additional paid-in capital, 12/31/87	675,000
Retained earnings, 12/31/87	425,000

The \$600,000 dividend includes a liquidating dividend of

- a. \$0
- b. \$175,000
- c. \$410,000
- d. \$485,000

Selected Questions

1N87#34. On June 30, 1987, Dorr, Inc. declared and issued a 10% common stock dividend. Prior to the dividend, Dorr had 30,000 shares of \$10 par common stock issued and outstanding. The market price of Dorr's common stock on June 30, 1987, was \$27 per share. As a result of this stock dividend, by what amount should Dorr's total stockholders' equity increase or (decrease)?

- a. (\$81,000)
- b. \$51,000
- c. \$30,000
- d. \$0

1M87#34. During 1987, Paul Company discovered that the ending inventories reported on its financial statements were incorrect by the following amounts:

1985	\$60,000 understated
1986	75,000 overstated

Paul uses the periodic inventory system to ascertain year-end quantities that are converted to dollar amounts using the FIFO cost method. Prior to any adjustments for these errors and ignoring income taxes, Paul's retained earnings at January 1, 1987, would be

- a. Correct.
- b. \$ 15,000 overstated.
- c. \$ 75,000 overstated.
- d. \$135,000 overstated.

1N86#31. On July 1, 1986, Bart Corporation has 200,000 shares of \$10 par common stock outstanding and the market price of the stock is \$12 per share. On the same date, Bart declared a 1-for-2 reverse stock split. The par of the stock was increased from \$10 to \$20 and one new \$20 par share was issued for each two \$10 par shares outstanding. Immediately before the 1-for-2 reverse stock split, Bart's additional paid-in capital was \$450,000. What should be the balance in Bart's additional paid-in capital account immediately after the reverse stock split is effected?

- a. \$0
- b. \$450,000
- c. \$650,000
- d. \$850,000

1N86#39. Huff, Inc., had marketable securities with a carrying amount of \$300,000 on December 20, 1985. On the same date a property dividend of these securities was declared. Pertinent information as to the fair value of the securities was as follows:

	<u>Fair value</u>
Declaration date — 12/20/85	\$390,000
Record date — 1/13/86	405,000
Distribution date — 1/27/86	400,000

For the year ended December 31, 1985, how much gain on disposal of marketable securities should Huff recognize as a result of this property dividend?

- a. \$0
- b. \$ 90,000
- c. \$100,000
- d. \$105,000

2N85

Items 12 through 16* are based on the following data:

Beef Corporation STOCKHOLDERS' EQUITY December 31, 1983

Common stock, \$1 par value; authorized 3,000,000 shares; issued 1,500,000 shares; outstanding 1,400,000 shares	\$ 1,400,000
Additional paid-in capital:	
In excess of par	14,000,000
From treasury stock	200,000
Total paid-in capital	15,600,000
Unappropriated retained earnings	8,100,000
Total stockholders' equity	<u>\$23,700,000</u>

All of the outstanding common stock and treasury stock were originally issued in 1981 for \$11.00 per share. The treasury stock is common stock reacquired on March 31, 1983. Beef uses the par value method of accounting for treasury stock.

During 1984 the following events or transactions occurred relating to Beef's stockholders' equity:

- February 12, 1984 — Issued 400,000 shares of unissued common stock for \$12.50 per share.
- June 15, 1984 — Declared a cash dividend of \$0.20 per share to stockholders of record on April 1, 1984, and payable on April 15, 1984. This was the first dividend ever declared by Beef.
- September 20, 1984 — Beef's president retired. Beef purchased from the retiring president 100,000 shares of Beef's common stock for \$13.00 per share, which was equal to market value on this date. This stock was cancelled.
- December 15, 1984 — Declared a cash dividend of \$0.20 per share to stockholders of record on January 2, 1985, and payable on January 15, 1985.
- At December 31, 1984, Beef is being sued by two separate parties for patent infringements. Beef's management and outside legal counsel share the following opinions regarding these suits:

<u>Suit</u>	<u>Likelihood of losing the suit</u>	<u>Estimated loss</u>
#1	Reasonably possible	\$600,000
#2	Probable	400,000

*The items omitted can be found in the other Content Specification Groups.

Accounting Practice

14. Beef wants to appropriate retained earnings for all loss contingencies that are not properly accruable by a charge to expense. How much of Beef's loss contingencies should be appropriated by a charge to unappropriated retained earnings?

- a. \$1,000,000
- b. \$ 600,000
- c. \$ 400,000
- d. \$0

15. How much in cash dividends should Beef charge against unappropriated retained earnings in 1984?

- a. \$700,000
- b. \$680,000
- c. \$360,000
- d. \$340,000

1M85#17. Terry, Inc., is a calendar-year corporation whose financial statements for 1983 and 1984 included errors as follows:

Year	Ending inventory	Depreciation expense
1983	\$15,000 overstated	\$12,500 overstated
1984	5,000 understated	4,000 understated

Assume that purchases were recorded correctly and that no correcting entries were made at December 31, 1983, or at December 31, 1984. Ignoring income taxes, by how much should Terry's retained earnings be retroactively adjusted at January 1, 1985?

- a. \$13,500 increase.
- b. \$ 3,500 decrease.
- c. \$ 1,500 decrease.
- d. \$ 1,000 increase.

1M85#18. On December 31, 1984, the stockholders' equity section of Bergen, Inc., was as follows:

Common stock, par value \$10; authorized 30,000 shares; issued and outstanding 9,000 shares	\$ 90,000
Additional paid-in capital	116,000
Retained earnings	146,000
Total stockholders' equity	<u>\$352,000</u>

On March 31, 1985, Bergen declared a 10% stock dividend, and accordingly 900 additional shares were issued, when the fair market value of the stock was \$16 per share. For the three months ended March 31, 1985, Bergen sustained a net loss of \$32,000. The balance of Bergen's retained earnings as of March 31, 1985, should be

- a. \$ 99,600
- b. \$105,000
- c. \$108,600
- d. \$114,000

1M85#24. Clay, Inc., owned 10,000 common shares of Dart Corporation purchased in 1980 for \$90,000. On September 20, 1984, Clay declared a property dividend

of one share of Dart for every five shares of Clay common stock held by a stockholder. On that date there were 50,000 common shares of Clay outstanding, and the market price of Dart shares was \$15 per share. The entry to record the declaration of the property dividend would include a debit to retained earnings of

- a. \$0
- b. \$ 60,000
- c. \$ 90,000
- d. \$150,000

D. Treasury Stock and Other Contra Accounts

2M89#4. In 1988, Newt Corp. acquired 6,000 shares of its own \$1 par value common stock at \$18 per share. In 1989, Newt issued 3,000 of these shares at \$25 per share. Newt uses the cost method to account for its treasury stock transactions. What accounts and amounts should Newt credit in 1989 to record the issuance of the 3,000 shares?

	Treasury stock	Additional paid-in capital	Retained earnings	Common stock
a.	\$54,000		\$21,000	
b.	\$54,000	\$21,000		
c.		\$72,000		\$3,000
d.		\$51,000	\$21,000	\$3,000

2M89#6. At December 31, 1987, Rama Corp. had 20,000 shares of \$1 par value treasury stock that had been acquired in 1987 at \$12 per share. In May 1988, Rama issued 15,000 of these treasury shares at \$10 per share. The cost method is used to record treasury stock transactions. Rama is located in a state where laws relating to acquisition of treasury stock restrict the availability of retained earnings for declaration of dividends. At December 31, 1988, what amount should Rama show in notes to financial statements as a restriction of retained earnings as a result of its treasury stock transactions?

- a. \$ 5,000
- b. \$10,000
- c. \$60,000
- d. \$90,000

1N88#44. Day Corp. holds 10,000 shares of its \$10 par value common stock as treasury stock reacquired in 1986 for \$120,000. On December 12, 1988, Day reissued all 10,000 shares for \$190,000. Under the cost method of accounting for treasury stock, the reissuance would result in a credit to

- a. Capital stock of \$100,000.
- b. Retained earnings of \$70,000.
- c. Gain on sale of investments of \$70,000.
- d. Additional paid-in capital of \$70,000.

1N86#32. Cox Corporation was organized on January 1, 1983, at which date it issued 100,000 shares of \$10 par common stock at \$15 per share. During the period January 1, 1983, through December 31, 1985, Cox re-

Selected Questions

ported net income of \$450,000 and paid cash dividends of \$230,000. On January 10, 1985, Cox purchased 6,000 shares of its common stock at \$12 per share. On December 31, 1985, Cox sold 4,000 treasury shares at \$8 per share. Cox uses the cost method of accounting for treasury shares. What is Cox's total stockholders' equity at December 31, 1985?

- a. \$1,720,000
- b. \$1,704,000
- c. \$1,688,000
- d. \$1,680,000

2N85

Items 12 through 16* are based on the following data:

Beef Corporation STOCKHOLDERS' EQUITY December 31, 1983

Common stock, \$1 par value; authorized 3,000,000 shares; issued 1,500,000 shares; outstanding 1,400,000 shares	\$ 1,400,000
Additional paid-in capital:	
In excess of par	14,000,000
From treasury stock	200,000
Total paid-in capital	15,600,000
Unappropriated retained earnings	8,100,000
Total stockholders' equity	<u>\$23,700,000</u>

All of the outstanding common stock and treasury stock were originally issued in 1981 for \$11.00 per share. The treasury stock is common stock reacquired on March 31, 1983. Beef uses the par value method of accounting for treasury stock.

During 1984 the following events or transactions occurred relating to Beef's stockholders' equity:

- February 12, 1984 — Issued 400,000 shares of unissued common stock for \$12.50 per share.
- June 15, 1984 — Declared a cash dividend of \$0.20 per share to stockholders of record on April 1, 1984, and payable on April 15, 1984. This was the first dividend ever declared by Beef.
- September 20, 1984 — Beef's president retired. Beef purchased from the retiring president 100,000 shares of Beef's common stock for \$13.00 per share, which was equal to market value on this date. This stock was cancelled.
- December 15, 1984 — Declared a cash dividend of \$0.20 per share to stockholders of record on January 2, 1985, and payable on January 15, 1985.

*The items omitted can be found in other Content Specification Groups.

- At December 31, 1984, Beef is being sued by two separate parties for patent infringements. Beef's management and outside legal counsel share the following opinions regarding these suits:

Suit	Likelihood of losing the suit	Estimated loss
#1	Reasonably possible	\$600,000
#2	Probable	400,000

16. How much should Beef show in notes to financial statements as a restriction on retained earnings because of the acquisition of treasury stock?

- a. \$ 200,000
- b. \$ 900,000
- c. \$1,200,000
- d. \$1,300,000

E. Stock Options, Warrants, and Rights

2M89#7. On January 1, 1987, Doro Corp. granted an employee an option to purchase 3,000 shares of Doro's \$5 par value common stock at \$20 per share. The option became exercisable on December 31, 1988, after the employee completed two years of service. The option was exercised on January 10, 1989. The market prices of Doro's stock were as follows:

January 1, 1987	\$30
December 31, 1988	50
January 10, 1989	45

For 1988, Doro should recognize compensation expense of

- a. \$45,000
- b. \$37,500
- c. \$15,000
- d. \$0

1N88#41. On January 1, 1987, Ward Corp. granted stock options to corporate executives for the purchase of 20,000 shares of the company's \$20 par value common stock at 80% of the market price on the exercise date, December 28, 1987. All stock options were exercised on December 28, 1987. The quoted market prices of Ward's \$20 par value common stock were as follows:

January 1, 1987	\$45
December 28, 1987	60

As a result of the exercise of the stock options and the issuance of the common stock, Ward should record a credit to additional paid-in capital of

- a. \$800,000
- b. \$740,000
- c. \$560,000
- d. \$500,000

Accounting Practice

1N87#40. On February 24, 1986, Bart Company purchased 2,000 shares of Winn Corp.'s newly issued 6% cumulative \$75 par preferred stock for \$152,000. Each share carried one detachable stock warrant entitling the holder to acquire at \$10, one share of Winn no-par common stock. On February 25, 1986, the market price of the preferred stock ex-warrants was \$72 a share and the market price of the stock warrants was \$8 a warrant. On December 29, 1986, Bart sold all the stock warrants for \$20,500. The gain on the sale of the stock warrants was

- a. \$0
- b. \$ 500
- c. \$4,500
- d. \$5,300

1N86#33. On January 1, 1984, Burr, Inc., granted its president an option to purchase 2,000 shares of Burr's stock at \$40 per share. The option became exercisable on December 31, 1985, after the president completed two years of service. The option was exercised early in 1986. The market prices of Burr's stock were as follows:

January 1, 1984	\$60
December 31, 1985	85

For 1985, Burr should recognize compensation expense of

- a. \$0
- b. \$20,000
- c. \$40,000
- d. \$45,000

F. Reorganization and Change in Entity

1N88#56. Howe, Inc. was organized to consolidate the resources of Ball Corp. and Cook Corp. in a business combination appropriately accounted for by the pooling of interests method. On January 1, 1988, Howe issued 60,000 shares of its \$10 par value common stock for all of the outstanding capital stock of Ball and Cook. The equity account balances of Ball and Cook on this date were:

	<u>Ball</u>	<u>Cook</u>	<u>Total</u>
Par value of common stock	\$150,000	\$400,000	\$550,000
Additional paid-in capital	30,000	85,000	115,000
Retained earnings	100,000	215,000	315,000
	<u>\$280,000</u>	<u>\$700,000</u>	<u>\$980,000</u>

What is the balance in Howe's additional paid-in capital account immediately after the business combination?

- a. \$0
- b. \$ 65,000
- c. \$115,000
- d. \$380,000

1M88#44. Kent, Inc. has been forced into bankruptcy and has begun to liquidate. Unsecured claims will be

paid at the rate of 40 cents on the dollar. Apex Co. holds a noninterest bearing note receivable from Kent in the amount of \$100,000, collateralized by machinery with a liquidation value of \$25,000. The total amount to be realized by Apex on this note receivable is

- a. \$25,000
- b. \$40,000
- c. \$55,000
- d. \$65,000

1N86#35. On January 1, 1985, Pitt Company purchased an 80% investment in Saxe Company. The acquisition cost was equal to Pitt's equity in Saxe's net assets at that date. On January 1, 1985, Pitt and Saxe had retained earnings of \$500,000 and \$100,000, respectively. During 1985: (1) Pitt had net income of \$200,000, which included its equity in Saxe's earnings, and declared dividends of \$50,000, (2) Saxe had net income of \$40,000 and declared dividends of \$20,000, and (3) there were no other intercompany transactions between the parent and subsidiary. On December 31, 1985, the consolidated retained earnings should be

- a. \$650,000
- b. \$666,000
- c. \$766,000
- d. \$770,000

2N85

Items 18 and 19 are based on the following data:

On January 1, 1984, Neel Corp. issued 400,000 additional shares of \$10 par value common stock in exchange for all of Pym Corp.'s common stock. Immediately before this business combination, Neel's stockholders' equity was \$16,000,000 and Pym's stockholders' equity was \$8,000,000. On January 1, 1984, fair market value of Neel's common stock was \$20 per share, and fair market value of Pym's net assets was \$8,000,000. Neel's net income for the year ended December 31, 1984, exclusive of any consideration of Pym, was \$2,500,000. Pym's net income for the year ended December 31, 1984, was \$600,000. During 1984 Neel paid dividends of \$900,000. Neel had no business transactions with Pym in 1984.

18. Assuming that this business combination is appropriately accounted for as a pooling of interests, consolidated stockholders' equity at December 31, 1984, should be

- a. \$17,600,000
- b. \$18,200,000
- c. \$26,200,000
- d. \$27,100,000

19. Assuming that this business combination is appropriately accounted for as a purchase, consolidated stockholders' equity at December 31, 1984, should be

- a. \$17,600,000
- b. \$18,200,000
- c. \$26,200,000
- d. \$27,100,000

Selected Questions

1M85#21. The December 31, 1984, condensed balance sheet of Dunn Services, an individual proprietorship, follows:

Current assets	\$140,000
Equipment (net)	130,000
	<u>\$270,000</u>
Liabilities	\$ 70,000
John Dunn, Capital	200,000
	<u>\$270,000</u>

Fair values at December 31, 1984, are as follows:

Current assets	\$160,000
Equipment	210,000
Liabilities	70,000

On January 2, 1985, Dunn Services was incorporated, with 5,000 shares of \$10 par value common stock issued. How much should be credited to additional paid-in capital?

- a. \$320,000
- b. \$250,000
- c. \$230,000
- d. \$200,000

G. Partnerships

2M89#5. The following condensed balance sheet is presented for the partnership of Axel, Barr, and Cain, who share profits and losses in the ratio of 4:3:3, respectively:

Cash	\$100,000
Other assets	300,000
Total	<u>\$400,000</u>
Liabilities	\$150,000
Axel, capital	40,000
Barr, capital	180,000
Cain, capital	30,000
Total	<u>\$400,000</u>

The partners agreed to dissolve the partnership after selling the other assets for \$200,000. Upon dissolution of the partnership, Axel should have received

- a. \$0
- b. \$40,000
- c. \$60,000
- d. \$70,000

2M89#9. On May 1, 1989, Cobb and Mott formed a partnership and agreed to share profits and losses in the ratio of 3:7, respectively. Cobb contributed a parcel of land that cost him \$10,000. Mott contributed \$40,000 cash. The land was sold for \$18,000 on May 1, 1989,

immediately after formation of the partnership. What amount should be recorded in Cobb's capital account on formation of the partnership?

- a. \$18,000
- b. \$17,400
- c. \$15,000
- d. \$10,000

2M89#10. The partnership agreement of Donn, Eddy, and Farr provides for annual distribution of profit or loss in the following sequence:

- Donn, the managing partner, receives a bonus of 10% of profit.
- Each partner receives 6% interest on average capital investment.
- Residual profit or loss is divided equally.

Average capital investments for 1988 were:

Donn	\$80,000
Eddy	50,000
Farr	30,000

What portion of the \$100,000 partnership profit for 1988 should be allocated to Farr?

- a. \$28,600
- b. \$29,800
- c. \$35,133
- d. \$41,600

1N88

Items 26 and 27 are based on the following:

On June 30, 1988, the condensed balance sheet for the partnership of Eddy, Fox, and Grimm, together with their respective profit and loss sharing percentages, was as follows:

Assets, net of liabilities	<u>\$320,000</u>
Eddy, capital (50%)	\$160,000
Fox, capital (30%)	96,000
Grimm, capital (20%)	64,000
	<u>\$320,000</u>

26. Eddy decided to retire from the partnership and by mutual agreement is to be paid \$180,000 out of partnership funds for his interest. Total goodwill implicit in the agreement is to be recorded. After Eddy's retirement, what are the capital balances of the other partners?

	<u>Fox</u>	<u>Grimm</u>
a.	\$ 84,000	\$56,000
b.	\$102,000	\$68,000
c.	\$108,000	\$72,000
d.	\$120,000	\$80,000

Accounting Practice

27. Assume instead that Eddy remains in the partnership and that Hamm is admitted as a new partner with a 25% interest in the capital of the new partnership for a cash payment of \$140,000. Total goodwill implicit in the transaction is to be recorded. Immediately after admission of Hamm, Eddy's capital account balance should be

- \$280,000
- \$210,000
- \$160,000
- \$140,000

1M87#33. On January 1, 1987, the partners of Cobb, Davis, and Eddy, who share profits and losses in the ratio of 5:3:2, respectively, decided to liquidate their partnership. On this date the partnership condensed balance sheet was as follows:

<u>Assets</u>	
Cash	\$ 50,000
Other assets	250,000
	<u>\$300,000</u>
<u>Liabilities and Capital</u>	
Liabilities	\$ 60,000
Cobb, capital	80,000
Davis, capital	90,000
Eddy, capital	70,000
	<u>\$300,000</u>

On January 15, 1987, the first cash sale of other assets with a carrying amount of \$150,000 realized \$120,000. Safe installment payments to the partners were made the same date. How much cash should be distributed to each partner?

<u>Cobb</u>	<u>Davis</u>	<u>Eddy</u>
a. \$15,000	\$51,000	\$44,000
b. \$40,000	\$45,000	\$35,000
c. \$55,000	\$33,000	\$22,000
d. \$60,000	\$36,000	\$24,000

1M87#40. Fox, Greg, and Howe are partners with average capital balances during 1986 of \$120,000, \$60,000, and \$40,000, respectively. Partners receive 10% interest on their average capital balances. After deducting salaries of \$30,000 to Fox and \$20,000 to Howe, the residual profit or loss is divided equally. In 1986 the partnership sustained a \$33,000 loss before interest and salaries to partners. By what amount should Fox's capital account change?

- \$ 7,000 increase.
- \$11,000 decrease.
- \$35,000 decrease.
- \$42,000 increase.

1N86#36. At December 31, 1985, Reed and Quinn are partners with capital balances of \$40,000 and \$20,000, and they share profit and loss in the ratio of 2:1, respectively. On this date Poe invests \$17,000 cash for a one-fifth interest in the capital and profit of the new partnership. Assuming that goodwill is **not** recorded, how much should be credited to Poe's capital account on December 31, 1985?

- \$12,000
- \$15,000
- \$15,400
- \$17,000

2N85

Items 10 and 11 are based on the following data:

The following condensed balance sheet is presented for the partnership of Lever, Polen, and Quint, who share profits and losses in the ratio of 4:3:3, respectively:

Cash	\$ 90,000
Other assets	830,000
Lever, loan	20,000
	<u>\$940,000</u>
Accounts payable	\$210,000
Quint, loan	30,000
Lever, capital	310,000
Polen, capital	200,000
Quint, capital	190,000
	<u>\$940,000</u>

10. Assume that the assets and liabilities are fairly valued on the balance sheet and that the partnership decides to admit Fahn as a new partner, with a 20% interest. No goodwill or bonus is to be recorded. How much should Fahn contribute in cash or other assets?

- \$140,000
- \$142,000
- \$175,000
- \$177,500

11. Assume that instead of admitting a new partner, the partners decide to liquidate the partnership. If the other assets are sold for \$700,000, how much of the available cash should be distributed to Lever?

- \$230,000
- \$238,000
- \$258,000
- \$310,000

1M85#22. Cody and Paul formed a partnership on April 1, 1985, and contributed the following assets:

	<u>Cody</u>	<u>Paul</u>
Cash	\$150,000	\$ 50,000
Land		310,000

Selected Questions

The land was subject to a mortgage of \$30,000, which was assumed by the partnership. Under the partnership agreement, Cody and Paul will share profit and loss in the ratio of one-third and two-thirds, respectively. Paul's capital account at April 1, 1985, should be

- a. \$300,000
- b. \$330,000
- c. \$340,000
- d. \$360,000

1M85#26. At December 31, 1984, Arno and Dey are partners with capital balances of \$80,000 and \$40,000,

and they share profit and loss in the ratio of 2:1, respectively. On this date West invests \$36,000 cash for a one-fifth interest in the capital and profit of the new partnership. The partners agree that the implied partnership goodwill is to be recorded simultaneously with the admission of West. The total implied goodwill of the firm is

- a. \$ 4,800
- b. \$ 6,000
- c. \$24,000
- d. \$30,000

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

A. Revenues and Gains

1M89#11. Lindy, a U.S. corporation, bought inventory items from a supplier in West Germany on November 5, 1987 for 100,000 marks, when the spot rate was \$.4295. At Lindy's December 31, 1987 year end, the spot rate was \$.4245. On January 15, 1988, Lindy bought 100,000 marks at the spot rate of \$.4345 and paid the invoice. How much should Lindy report in its income statements for 1987 and 1988 as foreign exchange gain or (loss)?

	<u>1987</u>	<u>1988</u>
a.	\$ 500	(\$1,000)
b.	\$0	(\$ 500)
c.	(\$ 500)	\$0
d.	(\$1,000)	\$ 500

1M89#50. Greg Corp. reported revenue of \$1,250,000 in its accrual basis income statement for the year ended June 30, 1989. Additional information was as follows:

Accounts receivable June 30, 1988	\$400,000
Accounts receivable June 30, 1989	530,000
Uncollectible accounts written off during the fiscal year	15,000

Under the cash basis, Greg should report revenue of

- a. \$ 835,000
- b. \$ 850,000
- c. \$1,105,000
- d. \$1,135,000

1M89#51. On January 2, 1988, Rex Enterprises, Inc. authorized Adam Company to operate as a franchisee over a 20-year period for an initial franchise fee of \$60,000 received on signing the agreement. Adam started operations on June 30, 1988, by which date Rex had performed all of the required initial services. In its income statement for the six months ended June 30,

1988, what amount should Rex report as revenue from franchise fees in connection with Adam's franchise?

- a. \$0
- b. \$ 1,500
- c. \$30,000
- d. \$60,000

1M89#53. Zach Company assigns some of its patents to other enterprises under a variety of licensing agreements. In some instances, advance royalties are received when the agreements are signed and, in others, royalties are remitted within 60 days after each license year end. The following data are included in Zach's December 31 balance sheets:

	<u>1987</u>	<u>1988</u>
Royalties receivable	\$90,000	\$85,000
Unearned royalties	60,000	40,000

During 1988, Zach received royalty remittances of \$200,000. In its income statement for the year ended December 31, 1988, Zach should report royalty revenue of

- a. \$225,000
- b. \$215,000
- c. \$205,000
- d. \$195,000

1M89#54. On January 1, 1988, Post Corp. leased a warehouse to Winn under an operating lease for ten years at \$60,000 per year, payable the first day of each lease year. Post paid \$27,000 to a real estate broker as a finder's fee. The warehouse is depreciated \$15,000 per year. For 1988, Post incurred insurance and property tax expense totaling \$12,000. Post's net rental income for 1988 should be

- a. \$33,000
- b. \$30,300
- c. \$21,000
- d. \$ 6,000

Accounting Practice

1M89#59. On January 1, 1987, Tone Company exchanged equipment for a \$200,000 noninterest bearing note due on January 1, 1990. The prevailing rate of interest for a note of this type at January 1, 1987 was 10%. The present value of \$1 at 10% for three periods is 0.75. What amount of interest revenue should be included in Tone's 1988 income statement?

- a. \$ 7,500
- b. \$15,000
- c. \$16,500
- d. \$20,000

1N88#31. On October 1, 1987, Yost Corp. acquired for cash all of the voting common stock of Leer, Inc. The purchase price of Leer's stock equaled the book value and fair value of Leer's net assets. The separate net income for each company, excluding Yost's share of income from Leer, was as follows:

	<u>Yost</u>	<u>Leer</u>
Twelve months ended 12/31/87	\$1,500,000	\$900,000
Three months ended 12/31/87	165,000	150,000

During September, Leer paid \$450,000 in dividends to its stockholders. For the year ended December 31, 1987, Yost Corp. issued parent company only financial statements. These statements are not considered to be those of the primary reporting entity. Under the equity method, what is the amount of net income reported in Yost's income statement?

- a. \$2,400,000
- b. \$1,950,000
- c. \$1,725,000
- d. \$1,650,000

1N88#33. In its accrual basis income statement for the year ended December 31, 1987, Glen Corp. reported revenue of \$1,550,000. Additional information was as follows:

Accounts receivable — December 31, 1986	\$350,000
Accounts receivable — December 31, 1987	\$550,000

Under the cash basis, how much should Glen report as revenue for 1987?

- a. \$1,000,000
- b. \$1,200,000
- c. \$1,350,000
- d. \$1,750,000

1N88#34. Lewis Company's usual sales terms are net 60 days, F.O.B. shipping point. Sales, net of returns and allowances, totaled \$2,300,000 for the year ended December 31, 1987, before year-end adjustments. Additional data are as follows:

- On December 27, 1987, Lewis authorized a customer to return, for full credit, goods shipped and billed at \$50,000 on December 15, 1987. The re-

turned goods were received by Lewis on January 4, 1988, and a \$50,000 credit memo was issued and recorded on the same date.

- Goods with an invoice amount of \$80,000 were billed and recorded on January 3, 1988. The goods were shipped on December 30, 1987.
- Goods with an invoice amount of \$100,000 were billed and recorded on December 30, 1987. The goods were shipped on January 3, 1988.

Lewis' adjusted net sales for 1987 should be

- a. \$2,330,000
- b. \$2,280,000
- c. \$2,250,000
- d. \$2,230,000

1N88#35. Hill Company began operations on January 1, 1987, and appropriately uses the installment method of accounting. Data available for 1987 are as follows:

Installment accounts receivable, 12/31/87	\$500,000
Installment sales	900,000
Cost of goods sold, as percentage of sales	60%

Using the installment method, Hill's realized gross profit for 1987 would be

- a. \$360,000
- b. \$240,000
- c. \$200,000
- d. \$160,000

1N88#36. On January 1, 1986, Mill Company sold a building and received as consideration \$100,000 cash and a \$400,000 noninterest bearing note due on January 1, 1989. There was no established exchange price for the building, and the note had no ready market. The prevailing rate of interest for a note of this type at January 1, 1986, was 10%. The present value of \$1 at 10% for three periods is 0.75. What amount of interest revenue should be included in Mill's 1987 income statement?

- a. \$44,000
- b. \$40,000
- c. \$33,333
- d. \$33,000

1N88#37. Dix Company acquired 2,000 shares of Lane, Inc. common stock on October 5, 1985, at a cost of \$44,000. On April 10, 1987, Lane distributed a 10% common stock dividend when the market price of the stock was \$30 per share. On December 20, 1987, Dix sold 200 shares of its Lane stock for \$6,400. For the year ended December 31, 1987, what amount should Dix report as dividend revenue?

- a. \$0
- b. \$2,400
- c. \$6,000
- d. \$6,400

1N88#38. On January 1, 1988, Ott Company sold goods to Fox Company. Fox signed a noninterest-bearing note requiring payment of \$60,000 annually for

Selected Questions

seven years. The first payment was made on January 1, 1988. The prevailing rate of interest for this type of note at date of issuance was 10%. Information on present value factors is as follows:

<i>Periods</i>	<i>Present value of 1 at 10%</i>	<i>Present value of ordinary annuity of 1 at 10%</i>
6	.56	4.36
7	.51	4.87

Ott should record sales revenue in January 1988 of

- a. \$321,600
- b. \$292,200
- c. \$261,600
- d. \$214,200

1N88#40. On January 2, 1987, Shaw Company sold the copyright to a book to Poe Publishers, Inc. for royalties of 20% of future sales. On the same date, Poe paid Shaw a royalty advance of \$100,000 to be applied against royalties for 1988 sales. On September 30, 1987, Poe made a \$42,000 royalty remittance to Shaw for sales in the six-month period ended June 30, 1987. In January 1988, before issuance of its 1987 financial statements, Shaw learned that Poe's sales of the book totaled \$250,000 for the last half of 1987. How much royalty revenue should Shaw report in its 1987 income statement?

- a. \$ 92,000
- b. \$142,000
- c. \$150,000
- d. \$192,000

1N88#42. During 1987, Kerr Company sold a parcel of land used as a plant site. The amount Kerr received was \$100,000 in excess of the land's carrying amount. Kerr's income tax rate for 1987 was 30%. In its 1987 income statement, Kerr should report a gain on sale of land of

- a. \$0
- b. \$ 30,000
- c. \$ 70,000
- d. \$100,000

1N88#45. Tara Company reported revenue of \$1,980,000 in its income statement for the year ended December 31, 1987. Additional information was as follows:

	<i>12/31/86</i>	<i>12/31/87</i>
Accounts receivable	\$415,000	\$550,000
Allowance for doubtful accounts	25,000	40,000

No uncollectible accounts were written off during 1987. Had the cash basis of accounting been used instead, Tara would have reported receipts for 1987 of

- a. \$2,115,000
- b. \$1,885,000
- c. \$1,860,000
- d. \$1,845,000

1M88#47. On September 1, 1987, Bain Corp. received an order for equipment from a foreign customer for 300,000 local currency units (LCU) when the U.S. dollar equivalent was \$96,000. Bain shipped the equipment on October 15, 1987, and billed the customer for 300,000 LCU when the U.S. dollar equivalent was \$100,000. Bain received the customer's remittance in full on November 16, 1987, and sold the 300,000 LCU for \$105,000. In its income statement for the year ended December 31, 1987, Bain should report a foreign exchange gain of

- a. \$0
- b. \$4,000
- c. \$5,000
- d. \$9,000

1N87#21. Lake Construction Company has consistently used the percentage-of-completion method of recognizing income. During 1985 Lake entered into a fixed-price contract to construct an office building for \$10,000,000. Information relating to the contract is as follows:

	<i>At December 31,</i>	
	<i>1985</i>	<i>1986</i>
Percentage of completion	20%	60%
Estimated total cost at completion	\$7,500,000	\$8,000,000
Income recognized (cumulative)	500,000	1,200,000

Contract costs incurred during 1986 were

- a. \$3,200,000
- b. \$3,300,000
- c. \$3,500,000
- d. \$4,800,000

1N87#30. Ball Corporation had the following infrequent gains during 1986:

- A \$240,000 gain on sale of a plant facility; Ball continues similar operations at another location.
- A \$90,000 gain on repayment of a long-term note denominated in a foreign currency.
- A \$190,000 gain on reacquisition and retirement of bonds.

In its 1986 income statement, how much should Ball report as total infrequent gains which are **not** considered extraordinary?

- a. \$520,000
- b. \$430,000
- c. \$330,000
- d. \$280,000

1N87#32. On July 1, 1986, Day Company purchased Parr Corp. ten-year, 8% bonds with a face amount of \$400,000 for \$358,000, which included \$8,000 of accrued interest. The bonds, which mature on April 1, 1994, pay interest semiannually on April 1 and October

Accounting Practice

1. Using the interest method, Day recorded bond discount amortization of \$1,500 for the six months ended December 31, 1986. From this long-term investment, Day should report 1986 revenue of

- \$14,000
- \$14,500
- \$16,000
- \$17,500

1N87#33. Adam Company received dividends from its common stock investments during the year ended December 31, 1986, as follows:

- A stock dividend of 200 shares from Brock Corp. was received on July 25, 1986, on which date the market price of Brock's shares was \$20 per share. Adam owns less than 1% of Brock's common stock.
- A cash dividend of \$60,000 from Celt Corp., in which Adam owns a 25% interest. A majority of Celt's directors are also directors of Adam.

What amount of dividend revenue should Adam report in its 1986 income statement?

- \$0
- \$ 4,000
- \$60,000
- \$64,000

1N87#36. Clay Company assigns patent rights, for which advance royalties are received in some cases and, in others, royalties are remitted within 60 days after each license year end. The following data are available from Clay's accounting records:

	At December 31,	
	1985	1986
Royalties receivable	\$75,000	\$80,000
Unearned royalties	45,000	65,000

During 1986 Clay received royalty remittances of \$250,000. In its 1986 income statement, Clay should report royalty revenue of

- \$225,000
- \$230,000
- \$235,000
- \$255,000

1N87#37. Conn Company purchased a new machine for \$480,000 on January 1, 1986, and leased it to East the same day. The machine has an estimated 12-year life, and will be depreciated \$40,000 per year. The lease is for a three-year period expiring January 1, 1989, at an annual rental of \$85,000. Additionally, East paid \$30,000 to Conn as a lease bonus to obtain the three-year lease. For 1986 Conn incurred insurance expense of \$8,000 for the leased machine. What is Conn's 1986 operating profit on this leased asset?

- \$67,000
- \$55,000
- \$47,000
- \$37,000

1N87#38. Mill Company began operations on January 1, 1985, and appropriately uses the installment method of accounting. The following data are available for 1985 and 1986:

	1985	1986
Installment sales	\$1,200,000	\$1,500,000
Cash collections from:		
1985 sales	400,000	500,000
1986 sales	—	600,000
Gross profit on sales	30%	40%

The realized gross profit for 1986 is

- \$240,000
- \$390,000
- \$440,000
- \$600,000

1N87#39. Rex Company accepted a \$10,000, 2% interest bearing note from Brooks Company on December 31, 1986, in exchange for a machine with a list price of \$8,000 and a cash price of \$7,500. The note is payable on December 31, 1988. In its 1986 income statement, Rex should report the sale at

- \$ 7,500
- \$ 8,000
- \$10,000
- \$10,400

1N87#35. Tone Company is the defendant in a lawsuit filed by Witt in 1985 disputing the validity of a copyright held by Tone. At December 31, 1985, Tone determined that Witt would probably be successful against Tone for an estimated amount of \$400,000. Appropriately, a \$400,000 loss was accrued by a charge to income for the year ended December 31, 1985. On December 15, 1986, Tone and Witt agreed to a settlement providing for cash payment of \$250,000 by Tone to Witt, and transfer of Tone's copyright to Witt. The carrying amount of the copyright on Tone's accounting records was \$60,000 at December 15, 1986. What would be the effect of the settlement on Tone's income before income tax in 1986?

- No effect.
- \$ 60,000 decrease.
- \$ 90,000 increase.
- \$150,000 increase.

1N87#36. Certain balance sheet accounts of a foreign subsidiary of Post, Inc., at December 31, 1986, have been translated into U.S. dollars as follows:

	Translated at	
	Current rates	Historical rates
Accounts receivable,		
long-term	\$120,000	\$100,000
Prepaid insurance	55,000	50,000
Copyright	75,000	85,000
	<u>\$250,000</u>	<u>\$235,000</u>

Selected Questions

The subsidiary's functional currency is the currency of the country in which it is located. What total amount should be included in Post's December 31, 1986 consolidated balance sheet for the above accounts?

- a. \$225,000
- b. \$235,000
- c. \$240,000
- d. \$250,000

1M87#39. On January 2, 1985, Winn Company purchased as a long-term investment 5,000 shares of Pyle Corp. common stock for \$70 per share, which represents a 1% interest. On December 31, 1985, the market price of the stock was \$75 per share. On December 18, 1986, Winn needed additional cash for operations and sold all 5,000 shares of Pyle stock for \$100 per share. Winn's income tax rate was 40% for 1986. For the year ended December 31, 1986, Winn should include in its income from continuing operations a gain on disposal of long-term investment of

- a. \$0
- b. \$ 75,000
- c. \$125,000
- d. \$150,000

2M87

Items 1 and 2 are based on the following data relating to a construction job started by Syl Co. during 1986:

Total contract price	\$100,000
Actual costs during 1986	20,000
Estimated remaining costs	40,000
Billed to customer during 1986	30,000
Received from customer during 1986	10,000

1. Under the completed contract method, how much should Syl recognize as gross profit for 1986?

- a. \$0
- b. \$ 4,000
- c. \$10,000
- d. \$12,000

2. Under the percentage-of-completion method, how much should Syl recognize as gross profit for 1986?

- a. \$0
- b. \$13,333
- c. \$26,667
- d. \$33,333

2M87#3. On January 1, 1986, Neu Co. sold equipment costing \$380,000, with accumulated depreciation of \$160,000 on the date of sale. Neu received as consideration for the sale a \$400,000 noninterest bearing note due January 1, 1989. There was no established exchange price for the equipment, and the note had no ready market. The prevailing rate of interest for a note of this type at January 1, 1986, was 10%. The present value of 1 at 10% for three periods is 0.75. In Neu's 1986 income statement, how much should be included for interest income?

- a. \$40,000
- b. \$33,333
- c. \$30,000
- d. \$13,500

2M87#13. On May 1, 1986, Lane Corp. bought a parcel of land for \$100,000. Seven months later, Lane sold this land to a triple-A rated company for \$150,000, under the following terms: 25% at closing, and a first mortgage note (at the market rate of interest) for the balance. The first payment on the note, plus accrued interest, is due December 1, 1987. Lane reported this sale on the installment basis in its 1986 tax return. In its 1986 income statement, how much gain should Lane report from the sale of this land?

- a. \$0
- b. \$12,500
- c. \$37,500
- d. \$50,000

2M87#14. James Lee, M.D., keeps his accounting records on a cash basis. During 1986, Dr. Lee collected \$100,000 in fees from his patients. At December 31, 1985, Dr. Lee had accounts receivable of \$20,000. At December 31, 1986, Dr. Lee had accounts receivable of \$30,000, and unearned fees of \$1,000. On an accrual basis, how much was Dr. Lee's patient service revenue for 1986?

- a. \$111,000
- b. \$109,000
- c. \$ 90,000
- d. \$ 89,000

2M87

Items 15 through 17 are based on the following data:

Lake Corporation's accounting records showed the following investments at January 1, 1986:

Common stock:

Kar Corp. (1,000 shares)	\$ 10,000
Aub Corp. (5,000 shares)	100,000

Real estate:

Parking lot (leased to Day Co.)	300,000
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Other:

Trademark (at cost, less accumulated amortization)	<u>25,000</u>
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Total investments	<u>\$435,000</u>
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Lake owns 1% of Kar and 30% of Aub. Lake's directors constitute a majority of Aub's directors. The Day lease, which commenced on January 1, 1984, is for ten years, at an annual rental of \$48,000. In addition, on January 1, 1984, Day paid a nonrefundable deposit of \$50,000, as well as a security deposit of \$8,000 to be refunded upon expiration of the lease. The trademark was licensed to Barr Co. for royalties of 10% of sales of the trademarked items. Royalties are payable semiannually on March 1 (for sales in July through December of the prior year), and on September 1 (for sales in January through June of the same year).

Accounting Practice

During the year ended December 31, 1986, Lake received cash dividends of \$1,000 from Kar, and \$15,000 from Aub, whose 1986 net incomes were \$75,000 and \$150,000, respectively. Lake also received \$48,000 rent from Day in 1986, and the following royalties from Barr:

	<u>March 1</u>	<u>September 1</u>
1985	\$3,000	\$5,000
1986	4,000	7,000

Barr estimated that sales of the trademarked items would total \$20,000 for the last half of 1986.

15. In Lake's 1986 income statement, how much should be reported for dividend revenue?

- a. \$16,000
- b. \$ 2,400
- c. \$ 1,000
- d. \$ 150

16. In Lake's 1986 income statement, how much should be reported for royalty revenue?

- a. \$14,000
- b. \$13,000
- c. \$11,000
- d. \$ 9,000

17. In Lake's 1986 income statement, how much should be reported for rental revenue?

- a. \$43,000
- b. \$48,000
- c. \$53,000
- d. \$53,800

2M87#19. In November and December 1986, Gee Co., a newly organized magazine publisher, received \$36,000 for 1,000 three-year subscriptions at \$12 per year, starting with the January 1987 issue of the magazine. Gee elected to include the entire \$36,000 in its 1986 income tax return. How much should Gee report in its 1986 income statement for subscriptions revenue?

- a. \$36,000
- b. \$12,000
- c. \$ 2,000
- d. \$0

2M87#20. Lin Co., a distributor of machinery, bought a machine from the manufacturer in November 1986 for \$10,000. On December 30, 1986, Lin sold this machine to Zee Hardware for \$15,000, under the following terms: 2% discount if paid within 30 days, 1% discount if paid after 30 days but within 60 days, or payable in full within 90 days if not paid within the discount periods. However, Zee had the right to return this machine to Lin if Zee was unable to resell the machine before expiration of the 90-day payment period, in which case Zee's obligation to Lin would be canceled. In Lin's net sales for the year ended December 31, 1986,

how much should be included for the sale of this machine to Zee?

- a. \$0
- b. \$14,700
- c. \$14,850
- d. \$15,000

1N86#29. Grey Company manufactures equipment which is sold or leased. On December 31, 1985, Grey leased equipment to Ray for a five-year period expiring December 31, 1990, at which date ownership of the leased asset will be transferred to Ray. Equal payments under the lease are \$40,000 and are due on December 31 of each year. The first payment was made on December 31, 1985. Collectibility of the remaining lease payments is reasonably assured and Grey has no material cost uncertainties. The normal sales price of the equipment is \$154,000 and cost is \$120,000. For the year ended December 31, 1985, how much income should Grey realize from the lease transaction?

- a. \$46,000
- b. \$40,000
- c. \$34,000
- d. \$0

1N86#30. Cord Builders, Inc., has consistently used the percentage-of-completion method of accounting for construction-type contracts. During 1984 Cord started work on a \$9,000,000 fixed-price construction contract that was completed in 1986. Cord's accounting records disclosed the following:

	<u>December 31,</u>	
	<u>1984</u>	<u>1985</u>
Cumulative contract costs incurred	\$3,900,000	\$6,300,000
Estimated total costs at completion	7,800,000	8,100,000

How much income would Cord have recognized on this contract for the year ended December 31, 1985?

- a. \$100,000
- b. \$300,000
- c. \$600,000
- d. \$700,000

1N86#34. Kew Company began operations on January 1, 1985, and appropriately uses the installment method of accounting. Data available for 1985 are as follows:

Installment accounts receivable, 12/31/85	\$500,000
Installment sales	900,000
Cost of goods sold, as percentage of sales	60%

Using the installment method, Kew's realized gross profit for 1985 would be

- a. \$160,000
- b. \$200,000
- c. \$240,000
- d. \$360,000

Selected Questions

1N86#37. In its accrual basis income statement for the year ended December 31, 1985, Dart Company reported revenue of \$1,750,000. Additional information was as follows:

Accounts receivable — 12/31/84	\$ 375,000
Uncollectible accounts written off during 1985	20,000
Accounts receivable — 12/31/85	505,000

Under the cash basis, how much should Dart report as revenue for 1985?

- a. \$1,620,000
- b. \$1,600,000
- c. \$1,395,000
- d. \$1,375,000

1N86#38. On January 2, 1985, Kemp Company assigned its patent to Wilson for royalties of 10% of patent related sales. The same date Kemp received a \$25,000 royalty advance to be applied against royalties for 1985 sales. On July 31, 1985, Wilson reported sales of \$200,000 for the six-month period ended June 30, 1985. In January 1986, before issuance of its 1985 financial statements, Kemp learned that Wilson's sales totaled \$275,000 for the last half of 1985. How much royalty income should Kemp report in its 1985 income statement?

- a. \$25,000
- b. \$45,000
- c. \$47,500
- d. \$52,500

1N86#40. On July 1, 1985, Fay Company purchased \$1,000,000 of West Company's 8% bonds due on July 1, 1995. Fay expects to hold the bonds until maturity. The bonds, which pay interest semiannually on January 1 and July 1, were purchased for \$875,000 to yield 10%. In its income statement for the year ended December 31, 1985, Fay should report interest income at

- a. \$35,000
- b. \$40,000
- c. \$43,750
- d. \$50,000

1N86#42. On January 1, 1985, Taft Company leased a warehouse to Green under an operating lease for ten years at \$40,000 per year, payable the first day of each lease year. Taft paid \$18,000 to a real estate broker as a finder's fee. The warehouse is depreciated \$10,000 per year. During 1985 Taft incurred insurance and property tax expense totaling \$7,500. Taft's net rental income for 1985 should be

- a. \$20,700
- b. \$22,000
- c. \$22,500
- d. \$30,000

1N86#43. Post, Inc., had a credit translation adjustment of \$30,000 for the year ended December 31, 1985. The functional currency of Post's subsidiary is the cur-

rency of the country in which it is located. Additionally, Post had a receivable from a foreign customer payable in the local currency of the customer. On December 31, 1984, this receivable for 200,000 local currency units (LCU) was correctly included in Post's balance sheet at \$110,000. When the receivable was collected on February 15, 1985, the United States dollar equivalent was \$120,000. In Post's 1985 consolidated income statement, how much should be reported as foreign exchange gain?

- a. \$0
- b. \$10,000
- c. \$30,000
- d. \$40,000

1M86#27. During 1985 Kew Company, a service organization, had \$200,000 in cash sales and \$3,000,000 in credit sales. The accounts receivable balances were \$400,000 and \$485,000 at December 31, 1984 and 1985, respectively. If Kew desires to prepare a cash basis income statement, how much should be reported as sales for 1985 on a cash basis?

- a. \$3,285,000
- b. \$3,200,000
- c. \$3,115,000
- d. \$2,915,000

1M86#30. Marr Construction Company has consistently used the percentage-of-completion method. On January 10, 1984, Marr began work on a \$6,000,000 construction contract. At the inception date, the estimated cost of construction was \$4,500,000. The following data relate to the progress of the contract:

Income recognized at 12/31/84	\$ 600,000
Cost incurred 1/10/84 through 12/31/85	3,600,000
Estimated cost to complete at 12/31/85	1,200,000

How much income should Marr recognize for the year ended December 31, 1985?

- a. \$300,000
- b. \$525,000
- c. \$600,000
- d. \$900,000

1M86#32. On November 30, 1985, North Company consigned 30 freezers to West Company for sale at \$800 each and paid \$600 in transportation costs. An account sales was received on December 30, 1985, from West reporting the sale of 10 freezers, together with a remittance of the \$6,800 balance due. The remittance was net of the agreed 15% commission. How much, and in what month, should North recognize as consignment sales revenue?

	<u>November 1985</u>	<u>December 1985</u>
a.	\$0	\$8,000
b.	\$0	\$7,800
c.	\$23,400	\$0
d.	\$24,000	\$0

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1M86#33. On December 31, 1984, Gill Company sold a plant facility to Cox, Inc., for \$2,100,000, when the plant had a carrying amount of \$1,400,000. Cox paid \$300,000 cash on December 31, 1984, and signed a \$1,800,000 note bearing interest at 10%, payable in six annual installments of \$300,000. Gill appropriately accounts for the sale under the installment method. On December 31, 1985, Cox paid \$300,000 principal and \$180,000 interest. For the year ended December 31, 1985, what total amount of income should Gill recognize from the plant sale and financing?

- a. \$0
- b. \$100,000
- c. \$180,000
- d. \$280,000

1M86#34. On January 1, 1985, Elia Company sold a building, which had a carrying amount of \$350,000, receiving a \$125,000 down payment and, as additional consideration, a \$400,000 noninterest bearing note due on January 1, 1988. There was no established exchange price for the building, and the note had no ready market. The prevailing rate of interest for a note of this type at January 1, 1985, was 10%. The present value of 1 at 10% for three periods is 0.75. What amount of interest income should be included in Elia's 1985 income statement?

- a. \$0
- b. \$30,000
- c. \$35,000
- d. \$40,000

1M86#35. On January 1, 1985, Bart Company acquired as a long-term investment for \$700,000, a 20% common stock interest in Hall Company when the fair value of Hall's net assets was \$3,500,000. Bart can exercise significant influence over operating and financial policies of Hall. For the year ended December 31, 1985, Hall reported net income of \$360,000, declared, and paid cash dividends of \$100,000. How much investment income from this investment should Bart report for 1985?

- a. \$92,000
- b. \$72,000
- c. \$52,000
- d. \$20,000

1M86#36. On November 1, 1985, Yost Corporation issued shares of its voting common stock in exchange for all of the voting common stock of Zeno, Inc., in a business combination appropriately accounted for by the pooling of interests method. The separate net income for each company was as follows:

	<u>Yost</u>	<u>Zeno</u>
12 months ended 12/31/85	\$1,500,000	\$900,000
2 months ended 12/31/85	165,000	150,000

During September Zeno paid \$450,000 in dividends to its stockholders. For the year ended December 31, 1985, the consolidated net income should be

- a. \$ 315,000
- b. \$1,650,000
- c. \$1,950,000
- d. \$2,400,000

1M86#38. Rice Company owns 300 shares of Wood Corporation common stock acquired on July 24, 1984, at a total cost of \$11,000. On December 2, 1985, Rice received 300 stock rights from Wood. Each right entitles the holder to acquire one share of stock for \$45. The market price of Wood's stock on this date, ex-rights, was \$50 and the market price of each right was \$5. Rice sold its rights the same date for \$5 a right less a \$90 commission. The gain from the sale of the rights should be reported by Rice at

- a. \$1,500
- b. \$1,410
- c. \$ 500
- d. \$ 410

1M86#39. Huff Company acquired 2,000 shares of Post, Inc., common stock on October 5, 1983, at a cost of \$44,000. On April 10, 1985, Post distributed a 10% common stock dividend when the market price of the stock was \$30 per share. On December 20, 1985, Huff sold 200 shares of its Post stock for \$6,400. For the year ended December 31, 1985, how much should Huff report as dividend income and gain on sale?

	<u>Dividend income</u>	<u>Gain on sale</u>
a.	\$0	\$2,400
b.	\$0	\$6,400
c.	\$6,000	\$ 400
d.	\$6,000	\$2,400

1M86#40. Kay Company, a lessor of office machines, purchased a new machine for \$600,000 on January 1, 1985, which was leased the same day to Lee. The machine will be depreciated \$55,000 per year. The lease is for a four-year period expiring January 1, 1989, and provides for annual rental payments of \$100,000 beginning January 1, 1985. Additionally, Lee paid \$64,000 to Kay as a lease bonus. In its 1985 income statement, what amount of revenue and expense should Kay report on this leased asset?

	<u>Revenue</u>	<u>Expense</u>
a.	\$100,000	\$0
b.	\$116,000	\$0
c.	\$116,000	\$55,000
d.	\$164,000	\$55,000

1M86#53. Town, a calendar-year corporation incorporated in January 1982, experienced a \$600,000 net operating loss (NOL) in 1985. For the years 1982-1984,

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Town reported a taxable income in each year, and a total of \$450,000 for the three years. Assume that: (1) there is no difference between pretax accounting income and taxable income for all years, (2) the income tax rate is 40% for all years, (3) the NOL will be carried back to the profit years 1982-1984 to the extent of \$450,000, and \$150,000 will be carried forward to future periods. Town believes that realization of the tax benefit of the loss carryforward is assured beyond any reasonable doubt. In its 1985 income statement, what amount should Town report as the reduction of loss due to NOL carryback and carryforward?

- a. \$180,000
- b. \$240,000
- c. \$270,000
- d. \$360,000

1N85#27. Ward Company's usual sales terms are net 60 days, F.O.B. shipping point. Sales, net of returns and allowances, totaled \$2,300,000 for the year ended December 31, 1984, before year-end adjustment. Additional data are as follows:

- On December 27, 1984, Ward authorized a customer to return, for full credit, goods shipped and billed at \$50,000 on December 15, 1984. The returned goods were received by Ward on January 4, 1985, and a \$50,000 credit memo was issued on the same date.
- Goods with an invoice amount of \$80,000 were billed to a customer on January 3, 1985. The goods were shipped on December 31, 1984.
- On January 5, 1985, a customer notified Ward that goods billed and shipped on December 23, 1984, were lost in transit. The invoice amount was \$100,000.

Ward's adjusted net sales for 1984 should be

- a. \$2,330,000
- b. \$2,280,000
- c. \$2,250,000
- d. \$2,230,000

1N85#28. Green Company, which began operations on January 1, 1984, appropriately uses the installment method of accounting. The following information is available for 1984:

Gross profit on sales	40%
Deferred gross profit at 12/31/84	\$240,000
Cash collected, including down payments	450,000

What is the total amount of Green's installment sales for 1984?

- a. \$ 600,000
- b. \$ 690,000
- c. \$ 850,000
- d. \$1,050,000

1N85#29. On January 1, 1984, Rex Company leased a machine to Lee Company for eight years, with \$10,000 payments due at the beginning of each year. The machine cost Rex \$47,900. The lease is appropriately accounted for as a sales-type lease by Rex. The present value of all rent payments over the lease term discounted appropriately at 10% was \$58,700. The estimated salvage value of the machine at the end of eight years is equal to the disposal costs. How much interest income should Rex record from the lease for the year ended December 31, 1984?

- a. \$4,790
- b. \$4,870
- c. \$5,870
- d. \$7,000

1N85#30. Pine Construction, Inc., has consistently used the percentage of completion method of recognizing income. In 1984 Pine started work on a \$9,000,000 construction contract, which was completed in 1985. The accounting records disclosed the following data for 1984:

Progress billings	\$3,300,000
Costs incurred	2,700,000
Collections	2,100,000
Estimated cost to complete	5,400,000

How much income should Pine have recognized in 1984?

- a. \$300,000
- b. \$450,000
- c. \$600,000
- d. \$700,000

1N85#32. Information pertaining to dividends from Fay Company's common stock investments during the year ended December 31, 1984, is as follows:

- Fay owns a 2% interest in Beal Corporation, which declared a cash dividend of \$300,000 on November 26, 1984, to shareholders of record on December 21, 1984, and payable on January 10, 1985.
- On October 15, 1984, Fay received a liquidating dividend of \$10,000 from Clay Mining Corporation. Fay owns a 5% interest in Clay.

How much dividend income should Fay report in its 1984 income statement?

- a. \$0
- b. \$ 6,000
- c. \$10,000
- d. \$16,000

1N85#33. During 1983 a textbook written by Burr Company personnel was sold to Fox Publishing, Inc., for royalties of 10% on sales. Royalties are receivable

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semiannually on March 31, for sales in July through December of the prior year, and on September 30, for sales in January through June of the same year.

- Royalty income of \$18,000 was accrued at 12/31/83 for the period July — December 1983.
- Royalty income of \$20,000 was received on 3/31/84, and \$26,000 on 9/30/84.
- Burr learned from Fox that sales subject to royalty were estimated at \$270,000 for the last half of 1984.

In its income statement for 1984, Burr should report royalty income at

- a. \$46,000
- b. \$48,000
- c. \$53,000
- d. \$55,000

1N85#35. Lundy, a U.S. corporation, bought inventory items from a supplier in West Germany on November 5, 1984, for 50,000 marks, when the spot rate was \$.4295. At Lundy's December 31, 1984, year end the spot rate was \$.4245. On January 15, 1985, Lundy bought 50,000 marks at the spot rate of \$.4345 and paid the invoice. How much should Lundy report in its income statements for 1984 and 1985 as foreign exchange gain or (loss)?

	<u>1984</u>	<u>1985</u>
a.	\$250	(\$500)
b.	(\$250)	\$0
c.	\$0	(\$250)
d.	\$0	\$0

1N85#36. Hall Company owns an office building and leases the offices under a variety of rental agreements involving rent paid monthly in advance and rent paid annually in advance. Not all tenants make timely payments of their rent. Hall's balance sheets contained the following data:

	<u>1983</u>	<u>1984</u>
Rentals receivable	\$ 4,800	\$ 6,200
Unearned rentals	16,000	12,000

During 1984 Hall received \$40,000 cash from tenants. How much rental revenue should Hall record for 1984?

- a. \$34,600
- b. \$37,400
- c. \$42,600
- d. \$45,400

1N85#39. Poe Company's depreciation policy on machinery and equipment is as follows:

- A full year's depreciation is taken in the year of an asset's acquisition.
- No depreciation is taken in the year of an asset's disposition.
- The estimated useful life is five years.
- The straight-line method is used.

On June 30, 1985, Poe sold for \$57,500 a machine acquired in 1982 for \$105,000. The accumulated depreciation for this machine was \$54,000 at December 31, 1984, and the original estimated salvage value was \$15,000. How much gain or (loss) on the disposal should Poe record in 1985?

- a. \$ 3,500
- b. \$ 6,500
- c. (\$ 8,500)
- d. \$15,500

1M85#23. Hansen Construction, Inc., has consistently used the percentage-of-completion method of recognizing income. During 1984 Hansen started work on a \$3,000,000 fixed-price construction contract. The accounting records disclosed the following data for the year ended December 31, 1984:

Costs incurred	\$ 930,000
Estimated cost to complete	2,170,000
Progress billings	1,100,000
Collections	700,000

How much loss should Hansen have recognized in 1984?

- a. \$230,000
- b. \$100,000
- c. \$ 30,000
- d. \$0

1M85#27. A foreign subsidiary of Decker Corporation has certain balance sheet accounts at December 31, 1984. Information relating to these accounts in U.S. dollars is as follows:

	<u>Translated at</u>	
	<u>Current rate</u>	<u>Historical rates</u>
Marketable securities, at cost	\$ 65,000	\$ 75,000
Inventories, at average cost	500,000	550,000
Patents	80,000	85,000
	<u>\$645,000</u>	<u>\$710,000</u>

What total amount should be included in Decker's December 31, 1984, consolidated balance sheet for the above accounts?

- a. \$710,000
- b. \$700,000
- c. \$660,000
- d. \$645,000

1M85#30. On January 1, 1984, Jasen, Inc., issued 200,000 additional shares of \$10 par value voting common stock in exchange for all of Wall Company's voting common stock in a business combination appropriately accounted for by the pooling of interests method. Net income for the year ended December 31, 1984, was \$800,000 for Wall and \$2,600,000 for Jasen, exclusive

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of any consideration of Wall. During 1984 Jasen paid \$1,800,000 in dividends to its stockholders and Wall paid \$500,000 in dividends to Jasen. What should be the consolidated net income for the year ended December 31, 1984?

- a. \$2,300,000
- b. \$2,900,000
- c. \$3,100,000
- d. \$3,400,000

1M85#31. On July 1, 1984, Dixon Company purchased Mill Corporation ten-year, 12% bonds with a face value of \$300,000 for \$324,000, which included \$12,000 of accrued interest. The bonds, which mature on March 1, 1991, pay interest semiannually on March 1 and September 1. Dixon appropriately uses the straight-line method of amortization. The amount of income Dixon should report for the calendar year 1984 as a result of this long-term investment is

- a. \$16,200
- b. \$17,100
- c. \$18,000
- d. \$30,000

1M85#32. On January 2, 1984, Kiner Company sold the copyright to a book to Western Publishers, Inc., for royalties of 20% of future sales. The same date Western paid Kiner a royalty advance of \$50,000 to be applied against royalties for 1985 sales. On September 30, 1984, Western made a \$21,000 royalties remittance to Kiner for sales in the six-month period ended June 30, 1984. In January 1985, before issuance of its 1984 financial statements, Kiner learned that Western's sales of the book totaled \$125,000 for the last half of 1984. How much royalty income should Kiner report in its 1984 income statement?

- a. \$21,000
- b. \$46,000
- c. \$71,000
- d. \$75,000

1M85#33. On January 1, 1984, Bishop Company, a lessor of office machines, purchased for \$650,000 a new machine, which is expected to have a ten-year life, and will be depreciated \$65,000 per year. The same day the machine was leased to Hall for a four-year period expiring January 1, 1988, at an annual rental of \$150,000. Hall also paid a nonrefundable lease fee of \$50,000 to Bishop on January 1, 1984. During 1984 Bishop incurred insurance and other related costs of \$18,000 under the lease. For the year ended December 31, 1984, what amount should Bishop report as operating profit on this leased asset?

- a. \$ 67,000
- b. \$ 79,500
- c. \$ 85,000
- d. \$117,000

1M85#34. Cox Company received dividends from its common stock investments during the year ended December 31, 1984, as follows:

- A cash dividend of \$5,000 from West Corporation, in which Cox owns a 2% interest.
- A cash dividend of \$50,000 from Bell Corporation, in which Cox owns a 30% interest. A majority of Cox's directors are also directors of Bell.
- A stock dividend of 300 shares from Mill Corporation was received on December 10, 1984, on which date the quoted market value of Mill's shares was \$10 per share. Cox owns less than 1% of Mill's common stock.

How much dividend income should Cox report in its 1984 income statement?

- a. \$ 5,000
- b. \$ 8,000
- c. \$55,000
- d. \$58,000

1M85#39. The validity of a patent held by Gordon Company was disputed by Ashley in a lawsuit filed against Gordon in 1983. At December 31, 1983, Gordon's counsel and management determined that it was probable that Ashley would be successful against Gordon for an estimated amount of \$350,000. Accordingly, a loss of \$350,000 was accrued by a charge to income for the year ended December 31, 1983. On December 31, 1984, Gordon and Ashley agreed to a settlement providing for: (1) assignment of Gordon's patent to Ashley, and (2) payment of \$200,000 by Gordon to Ashley. The carrying value of the patent on Gordon's books was \$90,000 at December 31, 1984. What would be the effect of the settlement of Ashley's lawsuit on Gordon's income before income tax in 1984?

- a. No effect.
- b. \$ 60,000 increase.
- c. \$150,000 increase.
- d. \$290,000 decrease.

1M85#50. Kew Company leased equipment to Pitt on January 1, 1984, for an eight-year period expiring December 31, 1991. Equal payments under the lease of \$300,000 are due on January 1 of each year. The first payment was made on January 1, 1984. The rate of interest contemplated by Kew and Pitt is 10%. The cash selling price of the equipment is \$1,760,000 and the cost of the equipment on Kew's accounting records is \$1,400,000. Kew appropriately recorded the lease as a sales-type lease. For the year ended December 31, 1984, what amount of profit on the sale and interest income should Kew record?

- a. \$0 and \$0.
- b. \$0 and \$80,000.
- c. \$360,000 and \$146,000.
- d. \$360,000 and \$176,000.

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B. Expenses and Losses

1M89#12. As an inducement to enter a lease, Arts, Inc., a lessor, grants Hompson Corp., a lessee, nine months of free rent under a five year operating lease. The lease is effective on July 1, 1988 and provides for monthly rental of \$1,000 to begin April 1, 1989.

In Hompson's income statement for the year ended June 30, 1989, rent expense should be reported as

- a. \$10,200
- b. \$ 9,000
- c. \$ 3,000
- d. \$ 2,550

1M89#19. During 1988, Rine Company incurred the following costs:

Research and development services performed by Lee Corp. for Rine	\$300,000
Testing for evaluation of new products	250,000
Laboratory research aimed at discovery of new knowledge	370,000
Routine design of tools, jigs, molds, and dies	100,000

In its income statement for the year ended December 31, 1988, Rine should report research and development expense of

- a. \$1,020,000
- b. \$ 920,000
- c. \$ 720,000
- d. \$ 670,000

1M89#20. The balance in Bart Corp.'s foreign exchange loss account was \$13,000 at December 31, 1988, before any necessary year-end adjustment relating to the following:

- Bart had a \$20,000 loss resulting from the translation of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 1988.
- Bart had an account payable to an unrelated foreign supplier payable in the local currency of the foreign supplier on January 27, 1989. The U.S. dollar equivalent of the payable was \$100,000 on the November 28, 1988 invoice date, and it was \$106,000 on December 31, 1988.

In Bart's 1988 consolidated income statement, what amount should be included as foreign exchange loss?

- a. \$33,000
- b. \$27,000
- c. \$19,000
- d. \$13,000

1M89#48. Cain Co. issued \$400,000 face amount of its 10% bonds on January 1, 1989 for \$354,118 to yield

the buyer a 12% effective rate of return. Interest is payable semiannually on January 1 and July 1. What amount would Cain report as interest expense in its June 30, 1989 income statement?

- a. \$18,753
- b. \$20,000
- c. \$21,247
- d. \$24,000

1M88#43. The following information is available for Mason Corp. for 1987:

Sales	\$100,000
Beginning inventory	36,000
Ending inventory	19,000
Freight out	9,000
Purchases	43,000

Mason's cost of goods sold for 1987 is

- a. \$52,000
- b. \$60,000
- c. \$69,000
- d. \$88,000

1M88#48. The following information is available from Dell Company's 1987 accounting records:

Purchases	\$530,000
Purchase discounts	10,000
Beginning inventory	160,000
Ending inventory	215,000
Freight-out	40,000

Dell's 1987 cost of goods sold is

- a. \$465,000
- b. \$475,000
- c. \$505,000
- d. \$585,000

1M88#49. At December 31, 1987, Cobb Company had a \$695,000 balance in its advertising expense account before any year-end adjustments relating to the following:

- Included in the \$695,000 is \$80,000 for printing sales catalogs for a January 1988 sales promotional campaign.
- Television advertising spots telecast during December 1987 were billed to Cobb on January 2, 1988. The invoice cost of \$45,000 was paid on January 11, 1988.

Cobb's advertising expense for the year ended December 31, 1987 should be

- a. \$740,000
- b. \$660,000
- c. \$615,000
- d. \$570,000

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1M88#51. Wren Company had the following account balances at December 31, 1987:

Accounts receivable	\$ 900,000
Allowance for doubtful accounts (before any provision for 1987 doubtful accounts expense)	16,000
Credit sales for 1987	1,750,000

Wren is considering the following methods of estimating doubtful accounts expense for 1987:

- Based on credit sales at 2%
- Based on accounts receivable at 5%

What amount should Wren charge to doubtful accounts expense under each method?

	<u>Percentage of credit sales</u>	<u>Percentage of accounts receivable</u>
a.	\$51,000	\$45,000
b.	\$51,000	\$29,000
c.	\$35,000	\$45,000
d.	\$35,000	\$29,000

1M88#52. On October 1, 1987, Dean Company leased office space at a monthly rental of \$30,000 for 10 years expiring September 30, 1997. As an inducement for Dean to enter into the lease, the lessor permitted Dean to occupy the premises rent-free from October 1 to December 31, 1987. For the year ended December 31, 1987, Dean should record rent expense of

- a. \$0
- b. \$29,250
- c. \$87,750
- d. \$90,000

1N87#42. The following information was taken from Kay Company's accounting records for the year ended December 31, 1986:

Increase in raw materials inventory	\$ 15,000
Decrease in finished goods inventory	35,000
Raw materials purchased	430,000
Direct-labor payroll	200,000
Factory overhead	300,000
Freight-out	45,000

There was no work-in-process inventory at the beginning or end of the year. Kay's 1986 cost of goods sold is

- a. \$950,000
- b. \$965,000
- c. \$975,000
- d. \$995,000

1N87#43. Korn Company incurred the following costs during 1986:

Modification to the formulation of a chemical product	\$135,000
Trouble-shooting in connection with break- downs during commercial production	150,000
Design of tools, jigs, molds and dies involving new technology	170,000
Seasonal or other periodic design changes to existing products	185,000
Laboratory research aimed at discovery of new technology	215,000

In its income statement for the year ended December 31, 1986, Korn should report research and development expense of

- a. \$520,000
- b. \$470,000
- c. \$385,000
- d. \$335,000

1N87#44. Orr Corporation had a realized foreign exchange loss of \$13,000 for the year ended December 31, 1986, and must also determine whether the following items will require year-end adjustment:

- Orr had a \$7,000 gain resulting from the translation of the accounts of its wholly owned foreign subsidiary for the year ended December 31, 1986.
- Orr had an account payable to an unrelated foreign supplier payable in the supplier's local currency. The U.S. dollar equivalent of the payable was \$60,000 on the October 31, 1986 invoice date, and it was \$64,000 on December 31, 1986. The invoice is payable on January 30, 1987.

In Orr's 1986 consolidated income statement, what amount should be included as foreign exchange loss?

- a. \$ 6,000
- b. \$10,000
- c. \$13,000
- d. \$17,000

1N87#45. Strand, Inc. provides an incentive compensation plan under which its president receives a bonus equal to 10% of the corporation's income in excess of \$200,000 before income tax but after deduction of the bonus. If income before income tax and bonus is \$640,000 and the tax rate is 40%, the amount of the bonus would be

- a. \$40,000
- b. \$44,000
- c. \$58,180
- d. \$64,000

1N87#46. Clark Company's allowance for doubtful accounts had a credit balance of \$12,000 at December 31, 1985. Clark accrues doubtful accounts expense at 4% of credit sales. During 1986 Clark's credit sales amounted to \$1,500,000, and uncollectible accounts totaling \$48,000 were written off. The aging of accounts

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receivable indicated that a \$50,000 allowance for doubtful accounts was required at December 31, 1986. Clark's doubtful accounts expense for 1986 would be

- a. \$48,000
- b. \$50,000
- c. \$60,000
- d. \$86,000

1M87#47. On May 15, 1986, Hart, Inc. approved a plan to dispose of a segment of its business. It is expected that the sale will occur on February 1, 1987, at a selling price of \$1,000,000. Disposal costs incurred by Hart totaled \$150,000, all of which were paid during 1986. The segment had actual or estimated operating losses as follows:

1/1/86 to 5/14/86	\$130,000
5/15/86 to 12/31/86	50,000
1/1/87 to 1/31/87	15,000

The carrying amount of the segment at the date of sale was expected to be \$1,750,000. Ignore the income tax effects. What amount should Hart report as a loss on disposal of the segment in its 1986 income statement?

- a. \$0
- b. \$900,000
- c. \$915,000
- d. \$965,000

1M87#31. The following information is available for Bart Company for 1986:

Disbursements for purchases	\$580,000
Increase in trade accounts payable	50,000
Decrease in merchandise inventory	20,000

Cost of goods sold for 1986 was

- a. \$650,000
- b. \$610,000
- c. \$550,000
- d. \$510,000

1M87#32. On July 1, 1986, Cody Company obtained a \$2,000,000, 180-day bank loan at an annual rate of 12%. The loan agreement requires Cody to maintain a \$400,000 compensating balance in its checking account at the lending bank. Cody would otherwise maintain a balance of only \$200,000 in this account. The checking account earns interest at an annual rate of 6%. Based on a 360-day year, the effective interest rate on the borrowing is

- a. 12.00%
- b. 12.67%
- c. 13.33%
- d. 13.50%

1M87#41. During 1986, Mason Company incurred the following costs:

Research and development services performed by Lee Corp. for Mason	\$300,000
Testing for evaluation of new products	250,000
Laboratory research aimed at discovery of new knowledge	370,000

In its income statement for the year ended December 31, 1986, Mason should report research and development expense of

- a. \$920,000
- b. \$670,000
- c. \$300,000
- d. \$250,000

1M87#42. Barr Company's unadjusted trial balance at December 31, 1986, included the following accounts:

	<u>Debit</u>	<u>Credit</u>
Allowance for doubtful accounts	\$ 3,200	
Sales		\$1,445,000
Sales returns	25,000	

Barr estimates its uncollectible receivables at 2% of net sales. For 1986, Barr should report doubtful accounts expense of

- a. \$31,600
- b. \$28,900
- c. \$28,400
- d. \$25,200

1M87#43. On January 2, 1986, for past services, Day Corp. granted Jan Bell, its president, 10,000 stock appreciation rights that are exercisable immediately and expire on January 2, 1989. On exercise, Bell is entitled to receive cash for the excess of the market price of the stock on the exercise date over the market price on the grant date. Bell did not exercise any of the rights during 1986. The market price of Day's stock was \$30 on January 2, 1986, and \$45 on December 31, 1986. As a result of the stock appreciation rights, Day should recognize compensation expense for 1986 of

- a. \$0
- b. \$ 50,000
- c. \$150,000
- d. \$300,000

1M87#44. Fay, Inc., was organized late in 1985 and began operations on January 1, 1986. Prior to the start of operations, the following costs were incurred:

Attorney's fees for incorporating	\$6,000
State incorporation filing fees	4,000

Fay amortizes organization costs over the maximum period allowable under GAAP. How much amortization should Fay record for the year ended December 31, 1986?

- a. \$ 150
- b. \$ 250
- c. \$1,200
- d. \$2,000

1M87#45. On January 1, 1986, Kerr Company signed a ten-year noncancelable lease for a new machine, requiring \$20,000 annual payments at the beginning of each year. The machine has a useful life of 15 years,

Selected Questions

with no salvage value. Title passes to Kerr at the lease expiration date. Kerr uses straight-line depreciation for all of its plant assets. Aggregate lease payments have a present value on January 1, 1986, of \$126,000, based on an appropriate rate of interest. For 1986, Kerr should record depreciation (amortization) expense for the leased machine at

- a. \$20,000
- b. \$12,600
- c. \$ 8,400
- d. \$0

1M87#48. During 1986 Rex Company purchased marketable equity securities as a short-term investment. The cost and market value at December 31, 1986, were as follows:

<u>Security</u>	<u>Cost</u>	<u>Market value</u>
A — 100 shares	\$ 2,800	\$ 3,400
B — 1,000 shares	17,000	15,300
C — 2,000 shares	31,500	29,500
	<u>\$51,300</u>	<u>\$48,200</u>

Rex sold 1,000 shares of Company B stock on January 31, 1987, for \$15 per share, incurring \$1,500 in brokerage commission and taxes. On the sale, Rex should report a realized loss of

- a. \$ 300
- b. \$1,800
- c. \$2,000
- d. \$3,500

1M87#52. Jason Company incurred the following infrequent losses during 1986:

- A major strike by employees shut down one of Jason's factories. Shutdown losses totaled \$180,000.
- A loss of \$100,000 from writedown of plant and equipment to estimated realizable value.
- A loss of \$150,000 on disposal of one of three similar factories.

In its 1986 income statement, how much should Jason report as total infrequent losses which are **not** considered extraordinary?

- a. \$250,000
- b. \$280,000
- c. \$330,000
- d. \$430,000

1N86#41. Paul Company has a recent gross profit history of 40% of net sales. The following data are available from Paul's accounting records for the three months ended March 31, 1986:

Inventory at 1/1/86	\$ 650,000
Purchases	3,200,000
Net sales	4,500,000
Purchase returns	75,000
Freight-in	50,000

Using the gross profit method, the estimated cost of goods sold for the three months ended March 31, 1986, should be

- a. \$1,800,000
- b. \$2,700,000
- c. \$3,775,000
- d. \$3,825,000

1N86#44. Rex Company's officers' compensation expense account had a balance of \$448,000 at December 31, 1985, before any appropriate year-end adjustment relating to the following:

- No salary accrual was made for December 30-31, 1985. Salaries for the two-day period totaled \$7,000.
- Bonuses to officers for 1985 were paid on January 31, 1986, in the total amount of \$125,000.

The adjusted balance for officers' compensation expense for the year ended December 31, 1985, should be

- a. \$448,000
- b. \$455,000
- c. \$573,000
- d. \$580,000

1N86#45. On January 1, 1985, Vick Company as lessee signed a ten-year noncancelable lease for a machine stipulating annual payments of \$20,000. The first payment was made on January 1, 1985. Vick appropriately treated this transaction as a capital lease. The ten lease payments have a present value of \$135,000 at January 1, 1985, based on implicit interest of 10%. For the year ended December 31, 1985, Vick should record interest expense of

- a. \$0
- b. \$ 6,500
- c. \$11,500
- d. \$13,500

1N86#46. Rapp Company purchased a machine on July 1, 1985, for \$600,000. The machine has an estimated useful life of five years and a salvage value of \$80,000. The machine is being depreciated from the date of acquisition by the 150% declining balance method. For the year ended December 31, 1985, Rapp should record depreciation expense on this machine of

- a. \$180,000
- b. \$120,000
- c. \$ 90,000
- d. \$ 78,000

1N86#47. Dell Corp. incurred the following costs during the year ended December 31, 1985:

Routine, on-going efforts to refine, enrich, or otherwise improve upon the qualities of an existing product	\$125,000
Design, construction, and testing of pre-production prototypes and models	110,000

Accounting Practice

Quality control during commercial production including routine testing of products 150,000

Laboratory research aimed at discovery of new knowledge 180,000

The total amount to be classified and expensed as research and development for 1985 is

- a. \$235,000
- b. \$275,000
- c. \$290,000
- d. \$330,000

1N86#48. On January 1, 1984, Poe Company acquired the copyright to a book owned by Roberts for royalties of 15% of future book sales. Royalties are payable on September 30 for sales in January through June of the same year, and on March 31 for sales in July through December of the preceding year. During 1984 and 1985, Poe remitted royalty checks to Roberts as follows:

	<u>March 31</u>	<u>September 30</u>
1984	\$—	\$24,000
1985	22,000	27,000

Poe's sales of the Roberts book totaled \$200,000 for the last half of 1985. In its 1985 income statement, Poe should report royalty expense relating to this book of

- a. \$46,000
- b. \$49,000
- c. \$51,000
- d. \$57,000

1N86#49. Effective with the year ended December 31, 1985, Hall Company adopted a new accounting method for estimating the allowance for doubtful accounts at the amount indicated by the year-end aging of accounts receivable. The following data are available:

Allowance for doubtful accounts, 1/1/85	\$25,000
Provision for doubtful accounts during 1985 (2% on credit sales of \$1,000,000)	20,000
Accounts written off, 11/30/85	20,500
Estimated uncollectible accounts per aging, 12/31/85	22,000

After year-end adjustment, the doubtful accounts expense for 1985 should be

- a. \$22,000
- b. \$20,500
- c. \$20,000
- d. \$17,500

1N86#50. Glen Apparel, Inc., leases and operates a retail store. The following information relates to the lease for the year ended December 31, 1985:

- The store lease, an operating lease, calls for fixed monthly rent of \$1,500 the first day of each

month, and additional rent equal to 6% of net sales over \$300,000 per calendar year. Net sales for 1985 are \$900,000.

- Additionally, Glen paid executory costs to the lessor for property taxes of \$5,000 and insurance of \$2,500.

For 1985 Glen's expenses relating to the store lease are

- a. \$25,500
- b. \$54,000
- c. \$59,000
- d. \$61,500

2N86#6. On January 1, 1985, Acar Co. agreed to grant its employees ten vested vacation days each year, with the provision that vacation days earned in a particular year could not be taken until the following year. For the year ended December 31, 1985, all five of Acar's employees earned \$100 per day each, and earned ten vacation days each. These vacation days were taken during the first half of 1986. Wage rates remained the same for 1986. In Acar's 1985 income statement, how much expense should be reported for compensated absences?

- a. \$0
- b. \$1,000
- c. \$2,500
- d. \$5,000

2N86#14. If one Canadian dollar can be exchanged for 90 cents of United States money, what fraction should be used to compute the indirect quotation of the exchange rate expressed in Canadian dollars?

- a. 1.10/1
- b. 1/1.10
- c. 1/.90
- d. .90/1

1M86#42. Clay Company borrows money under various loan agreements involving notes discounted and notes requiring interest payments at maturity. During the year ended December 31, 1985, Clay paid interest totaling \$100,000. Clay's December 31 balance sheets included the following information:

	<u>1984</u>	<u>1985</u>
Prepaid interest	\$23,500	\$18,000
Interest payable	45,000	53,500

How much interest expense should Clay report for 1985?

- a. \$ 86,000
- b. \$ 97,000
- c. \$103,000
- d. \$114,000

1M86#43. On December 1, 1985, Kent Company leased office space for five years at a monthly rental of \$30,000. On the same date Kent paid the lessor the following amounts:

Selected Questions

First month's rent	\$ 30,000
Last month's rent	30,000
Security deposit (refundable at lease expiration)	40,000
Installation of new walls and offices	180,000

Kent's 1985 expense relating to utilization of the office space should be

- a. \$30,000
- b. \$33,000
- c. \$60,000
- d. \$70,000

1M86#44. Glen Company has the following data pertaining to the year ended December 31, 1985:

Purchases	\$450,000
Beginning inventory	170,000
Ending inventory	210,000
Freight-in	50,000
Freight-out	75,000

How much is the cost of goods sold for 1985?

- a. \$385,000
- b. \$460,000
- c. \$485,000
- d. \$540,000

1M86#45. Burg Company provides an incentive compensation plan granting its president a bonus equal to 10% of Burg's income in excess of \$220,000 after the bonus but before income tax. In 1985 Burg's income before bonus and income tax was \$550,000. The amount of the bonus for 1985 would be

- a. \$50,000
- b. \$36,300
- c. \$33,000
- d. \$30,000

1M86#46. Ward Company incurred research and development costs in 1985 as follows:

Equipment acquired for use in various research and development projects	\$975,000
Depreciation on the above equipment	135,000
Materials used	200,000
Compensation costs of personnel	500,000
Outside consulting fees	150,000
Indirect costs appropriately allocated	250,000

The total research and development costs charged in Ward's 1985 income statement should be

- a. \$ 850,000
- b. \$1,085,000
- c. \$1,235,000
- d. \$1,825,000

1M86#47. On January 1, 1980, Ball, Inc., purchased a \$1,000,000 ordinary life insurance policy on its president. The policy year and Ball's accounting year coincide. Additional data are available for the year ended December 31, 1985:

Cash surrender value, 1/1/85	\$43,500
Cash surrender value, 12/31/85	54,000
Annual advance premium paid 1/1/85	20,000
Dividend received 7/1/85	3,000

Ball, Inc., is the beneficiary under the life insurance policy. How much should Ball report as life insurance expense for 1985?

- a. \$ 6,500
- b. \$ 9,500
- c. \$17,000
- d. \$20,000

1M86#48. Based on the aging of its accounts receivable at December 31, 1985, Terry Company determined that the net realizable value of the receivables at that date is \$190,000. Additional information is as follows:

Accounts receivable at 12/31/85	\$220,000
Allowance for doubtful accounts at 1/1/85 — credit balance	32,000
Accounts written off as uncollectible at 9/30/85	24,000

Terry's doubtful accounts expense for the year ended December 31, 1985, is

- a. \$38,000
- b. \$30,000
- c. \$26,000
- d. \$22,000

1M86#54. Rago Company takes a full year's depreciation expense in the year of an asset's acquisition, and no depreciation expense in the year of disposition. Data relating to one of Rago's depreciable assets at December 31, 1984, are as follows:

Acquisition year	1982
Cost	\$110,000
Residual value	20,000
Accumulated depreciation	72,000
Estimated useful life	5 years

Using the same depreciation method as used in 1982, 1983, and 1984, how much depreciation expense should Rago record in 1985 for this asset?

- a. \$12,000
- b. \$18,000
- c. \$22,000
- d. \$24,000

1M86#55. Lane Company acquires copyrights from authors, paying advance royalties in some cases, and in others, paying royalties within 30 days of year end. Lane reported royalty expense of \$375,000 for the year ended December 31, 1985. The following data are included in Lane's December 31 balance sheets:

	1984	1985
Prepaid royalties	\$60,000	\$50,000
Royalties payable	75,000	90,000

Accounting Practice

During 1985 Lane made royalty payments totaling

- \$350,000
- \$370,000
- \$380,000
- \$400,000

1M86#56. On July 1, 1984, Clark Company borrowed 1,680,000 local currency units (LCU) from a foreign lender, evidenced by an interest bearing note due on July 1, 1985, which is denominated in the currency of the lender. The U.S. dollar equivalent of the note principal was as follows:

<u>Date</u>	<u>Amount</u>
7/1/84 (date borrowed)	\$210,000
12/31/84 (Clark's year end)	240,000
7/1/85 (date repaid)	280,000

In its income statement for 1985, what amount should Clark include as a foreign exchange gain or loss?

- \$70,000 gain.
- \$70,000 loss.
- \$40,000 gain.
- \$40,000 loss.

1M86#60. Graf Company purchased a machine that was installed and placed in service on January 2, 1984, at a total cost of \$120,000. Residual value was estimated at \$20,000. The machine is being depreciated over ten years by the double declining balance method. For the year 1985, Graf should record depreciation expense of

- \$10,800
- \$16,000
- \$19,200
- \$24,000

1N85#37. Zeno Menswear, Inc., maintains a markup of 60% based on cost. The company's selling and administrative expenses average 30% of sales. For 1984 sales amounted to \$960,000. Zeno's cost of goods sold and operating profit for 1984 are

	<u>Cost of goods sold</u>	<u>Operating profit</u>
a.	\$576,000	\$ 96,000
b.	\$576,000	\$288,000
c.	\$600,000	\$ 72,000
d.	\$600,000	\$288,000

1N85#38. On January 1, 1984, Orr Company bought a building which had an assessed value of \$220,000 on the date of purchase. Orr gave as consideration a \$400,000 noninterest bearing note due on January 1, 1987. There was no established exchange price for the building, and the note had no ready market. The prevailing rate of interest for a note of this type at January 1, 1984, was 10%. The present value of 1 at 10% for

three periods is 0.75. What amount of interest expense should be included in Orr's 1984 income statement?

- \$22,000
- \$30,000
- \$33,333
- \$40,000

1N85#40. In January 1984 Huff Mining Corporation purchased a mineral mine for \$3,600,000 with removable ore estimated by geological surveys at 2,160,000 tons. The property has an estimated value of \$360,000 after the ore has been extracted. Huff incurred \$1,080,000 of development costs preparing the property for the extraction of ore. During 1984, 270,000 tons were removed and 240,000 tons were sold. For the year ended December 31, 1984, Huff should include what amount of depletion in its cost of goods sold?

- \$360,000
- \$405,000
- \$480,000
- \$540,000

1N85#42. Colt Company prepared an aging of its accounts receivable at December 31, 1984, and determined that the net realizable value of the receivables is \$125,000. Additional information is available as follows:

Allowance for doubtful accounts at 1/1/84 — credit balance	\$ 14,000
Accounts written off as uncollectible during 1984	11,500
Accounts receivable at 12/31/84	135,000

For the year ended December 31, 1984, Colt's bad debt expense would be

- \$ 7,500
- \$10,000
- \$11,500
- \$12,500

1N85#43. On January 1, 1984, Marsh Company sold an airplane with an estimated useful life of ten years. At the same time, Marsh leased back the airplane for three years under a lease classified as an operating lease. Pertinent data are:

Sales price	\$500,000
Book value of airplane	100,000
Monthly rental under leaseback	5,100
Present value of lease rentals	153,000

For the year ended December 31, 1984, Marsh's rent expense for the airplane should be

- \$0
- \$10,200
- \$51,000
- \$61,200

Selected Questions

1M85#44. On January 3, 1983, Trapp Company purchased as a long-term investment 10,000 shares of Lee Corporation common stock for \$30 per share. On December 31, 1983, the market price of the stock was \$25 per share, reflecting a temporary decline in market value. On December 10, 1984, Trapp sold all 10,000 shares of Lee stock for \$10 per share. For the year ended December 31, 1984, Trapp should include in its income from continuing operations a loss on disposal of long-term investment of

- a. \$0
- b. \$ 50,000
- c. \$150,000
- d. \$200,000

1M85#46. On January 1, 1984, Beal Corporation granted stock options to key employees for the purchase of 20,000 shares of the company's common stock at \$25 per share. The options are intended to compensate employees for the next two years. The options are exercisable within a four-year period beginning January 1, 1986, by grantees still in the employ of the company. The market price of Beal's common stock was \$33 per share at the date of grant. No stock options were terminated during the year. How much should Beal charge to compensation expense for the year ended December 31, 1984?

- a. \$0
- b. \$ 40,000
- c. \$ 80,000
- d. \$160,000

1M85#35. The following expenses were recognized by Rex Company, a retailer, during 1984:

Accounting and legal fees	\$240,000
Loss on sale of long-term investment	110,000
Property taxes and insurance	150,000
Interest	90,000

How much of these expenses should be included in Rex's general and administrative expenses for 1984?

- a. \$390,000
- b. \$440,000
- c. \$480,000
- d. \$500,000

1M85#36. The following information is available for Day Company for 1984:

Disbursements for purchases of merchandise	\$290,000
Increase in trade accounts payable	25,000
Decrease in merchandise inventory	10,000

How much is the cost of goods sold for 1984?

- a. \$255,000
- b. \$275,000
- c. \$305,000
- d. \$325,000

1M85#38. On January 1, 1984, Parke Company borrowed \$360,000 from a major customer evidenced by a noninterest bearing note due in three years. Parke agreed to supply the customer's inventory needs for the loan period at lower than market price. At the 12% imputed interest rate for this type of loan, the present value of the note is \$255,000 at January 1, 1984. What amount of interest expense should be included in Parke's 1984 income statement?

- a. \$43,200
- b. \$35,000
- c. \$30,600
- d. \$0

1M85#41. A wholly owned subsidiary of Ward, Inc., has certain expense accounts for the year ended December 31, 1984, stated in local currency units (LCU) as follows:

	<u>LCU</u>
Depreciation of equipment (related assets were purchased January 1, 1982)	120,000
Provision for doubtful accounts	80,000
Rent	200,000

The exchange rates at various dates are as follows:

	<u>Dollar equivalent of 1 LCU</u>
December 31, 1984	\$.40
Average for year ended 12/31/84	.44
January 1, 1982	.50

Assume that the LCU is the subsidiary's functional currency and that the charges to the expense accounts occurred approximately evenly during the year. What total dollar amount should be included in Ward's 1984 consolidated income statement to reflect these expenses?

- a. \$160,000
- b. \$168,000
- c. \$176,000
- d. \$183,200

1M85#43. Cooke Company acquires patent rights from other enterprises and pays advance royalties in some cases, and in others, royalties are paid within 90 days after year end. The following data are included in Cooke's December 31 balance sheets:

	<u>1983</u>	<u>1984</u>
Prepaid royalties	\$55,000	\$45,000
Royalties payable	80,000	75,000

During 1984 Cooke remitted royalties of \$300,000. In its income statement for the year ended December 31, 1984, Cooke should report royalty expense of

- a. \$295,000
- b. \$305,000
- c. \$310,000
- d. \$330,000

Accounting Practice

1M85#44. On December 31, 1984, Hurd Company signed an operating lease for a warehouse for ten years at \$24,000 per year. Upon execution of the lease, Hurd paid \$48,000 covering rent for the first two years. How much should be shown in Hurd's income statement for the year ended December 31, 1984, as rent expense?

- a. \$0
- b. \$ 2,000
- c. \$24,000
- d. \$48,000

1M85#45. On January 1, 1983, for past services, Diven Company granted Mary Allen, its president, 5,000 stock appreciation rights which are exercisable immediately and expire three years after date of grant. On exercise, Allen is entitled to receive cash for the excess of the market value of the stock on the exercise date over the market value on the grant date. Allen exercised all of the rights on December 31, 1984. The per share market prices of Diven's stock were as follows:

January 1, 1983	\$25
December 31, 1983	30
December 31, 1984	40

As a result of the stock rights, Diven should recognize compensation expense in 1984 of

- a. \$0
- b. \$ 50,000
- c. \$ 75,000
- d. \$200,000

C. Provision for Income Tax

In November 1987, the FASB issued *Statement of Financial Accounting Standards No. 96*, "Accounting for Income Taxes," superseding *APB Opinion No. 11*, "Accounting for Income Taxes." Accordingly, all previous examination items covered by *APB Opinion No. 11* have been deleted.

D. Recurring Versus Nonrecurring Transactions and Events

1M89#60. On April 30, 1988, Wall Corp. approved a plan to dispose of a segment of its business. For the period January 1 through April 30, 1988, the segment had revenues of \$600,000 and expenses of \$750,000. The assets of the segment were sold on October 15, 1988 at a loss, from which no tax benefit is available. In its income statement for the year ended December 31, 1988, how should Wall report the segment's operations from January 1 to April 30, 1988?

- a. \$600,000 and \$750,000 should be included with revenues and expenses, respectively, as part of continuing operations.
- b. \$150,000 should be reported as part of the loss on disposal of a segment.
- c. \$150,000 should be reported as an extraordinary loss.
- d. \$150,000 should be reported as a loss from operations of a discontinued segment.

1N88#45. On October 1, 1987, Burns Corp. approved a formal plan to sell Hall division, a business segment. The sale was scheduled to take place on March 31, 1988. Hall had operating income of \$100,000 for the quarter ended December 31, 1987, and expected to incur an operating loss of \$50,000 for the first quarter of 1988. Burns estimated that it would incur a \$375,000 loss on the sale of Hall's assets. Burns' income tax rate for 1987 was 30%. In its 1987 income statement, Burns should report a loss on the disposal of Hall division of

- a. \$325,000
- b. \$297,500
- c. \$262,500
- d. \$227,500

1N88#47. Burl Company incurred the following loss and realized the following gain during 1987:

- \$50,000 loss as the result of an unanticipated strike by its employees.
- \$25,000 gain as the result of the early extinguishment of bonds payable.

Burl's income tax rate for 1987 was 30%. Burl's 1987 income statement should report an extraordinary loss and an extraordinary gain of

	<u>Extraordinary loss</u>	<u>Extraordinary gain</u>
a.	\$0	\$0
b.	\$0	\$17,500
c.	\$35,000	\$0
d.	\$35,000	\$17,500

1N87#41. On October 1, 1986, Poe Corporation's operating plant, located in Kansas, was destroyed by an earthquake. The portion of the resultant loss not covered by insurance was \$1,400,000. Poe's income tax rate for 1986 is 40%. In Poe's income statement for the year ended December 31, 1986, this event should be reported as an extraordinary loss of

- a. \$0
- b. \$ 560,000
- c. \$ 840,000
- d. \$1,400,000

1M87#49. On December 31, 1986, King Company appropriately changed to the FIFO cost method from the weighted-average cost method for financial statement and income tax purposes. The change will result in a \$350,000 increase in the beginning inventory at January 1, 1986. Assuming a 40% income tax rate, the cumulative effect of this accounting change reported for the year ended December 31, 1986, is

- a. \$350,000
- b. \$210,000
- c. \$140,000
- d. \$0

1M87#51. On January 1, 1986, Kern Company entered into an agreement to sell the assets and product line of its Zeno Division, considered a segment of the

Selected Questions

business. The sale was consummated on December 31, 1986, and resulted in a gain on disposition of \$800,000. The division's operations resulted in losses before income tax of \$450,000 in 1986 and \$250,000 in 1985. Kern's income tax rate is 40% for both years. In a comparative statement of income for 1986 and 1985, as components under the caption Discontinued Operations, Kern should report gain (loss) amounting to

	<u>1986</u>	<u>1985</u>
a.	\$210,000	(\$150,000)
b.	\$210,000	\$0
c.	(\$270,000)	(\$150,000)
d.	(\$270,000)	\$0

1M87#59. Hull Company is indebted to Apex under a \$500,000, 12%, three-year note dated December 31, 1984. Because of Hull's financial difficulties developing in 1986, Hull owed accrued interest of \$60,000 on the note at December 31, 1986. Under a troubled debt restructuring, on December 31, 1986, Apex agreed to settle the note and accrued interest for a tract of land having a fair value of \$450,000. Hull's acquisition cost of the land is \$360,000. Ignoring income taxes, on its 1986 income statement Hull should report as a result of the troubled debt restructuring

	<u>Other income</u>	<u>Extraordinary gain</u>
a.	\$200,000	\$0
b.	\$140,000	\$0
c.	\$ 90,000	\$ 50,000
d.	\$ 90,000	\$110,000

2N86

Items 7 through 10* are based on the following data:

When Key Co. commenced business operations on January 1, 1983, the following assets were among those acquired at that date:

Real estate

Cost of parcel of land	\$ 20,000
Cost of razing old structure which had been on the land	3,000
Title insurance and legal fees pertaining to land acquisition	5,000
Architect's fees	30,000
Cost of constructing new building	600,000

Machinery

Cost	100,000
Residual value	10,000
Estimated useful life (double-declining-balance method)	4 years

*The items omitted can be found in other Content Specification Groups.

In 1985, Key incurred the following losses:

Foreign exchange loss because of major devaluation of foreign currency	\$ 17,000
Effects of a strike against Key's major supplier	120,000

Also during 1985, the following gains were recognized:

Income tax benefit arising from operating loss carryforward	\$ 80,000
Gain on sale of real estate used in operations	300,000

9. For the year ended December 31, 1985, the extraordinary losses, before income tax considerations, amounted to

- a. \$0
- b. \$ 17,000
- c. \$120,000
- d. \$137,000

10. For the year ended December 31, 1985, the extraordinary gains, before income tax considerations, amounted to

- a. \$0
- b. \$ 80,000
- c. \$300,000
- d. \$380,000

1M86#41. Colt, Inc., is indebted to Kent under an \$800,000, 10%, four-year note dated December 31, 1982. Annual interest of \$80,000 was paid on December 31, 1983 and 1984. During 1985 Colt experienced financial difficulties and is likely to default unless concessions are made. On December 31, 1985, Kent agreed to restructure the debt as follows:

- Interest of \$80,000 for 1985, due December 31, 1985, was made payable December 31, 1986.
- Interest for 1986 was waived.
- The principal amount was reduced to \$700,000.

Assuming an income tax rate of 40%, how much should Colt report as extraordinary gain in its income statement for the year ended December 31, 1985?

- a. \$0
- b. \$ 60,000
- c. \$100,000
- d. \$108,000

1M86#59. On October 1, 1985, Mann Company approved a formal plan to sell Mill Division, considered a segment of the business. The sale will occur on March 31, 1986. The division had operating income of \$500,000 for the quarter ended December 31, 1985, but expects to incur an operating loss of \$100,000 for the first quarter of 1986. Mann also estimates that it will

Accounting Practice

incur a loss of \$750,000 on the sale of the division's assets. Mann's tax rate for 1985 is 40%. In its income statement for the year ended December 31, 1985, how much gain or loss should Mann report on disposal of Mill Division?

- a. \$210,000 loss.
- b. \$300,000 gain.
- c. \$350,000 loss.
- d. \$500,000 gain.

1N85#48. Rice, Inc., incurred the following losses, net of applicable taxes, for the year ended December 31, 1984:

Loss on disposal of a segment of Rice's business	\$350,000
Foreign currency transaction loss due to major devaluation	450,000

How much should Rice report as extraordinary losses in its 1984 income statement?

- a. \$0
- b. \$350,000
- c. \$450,000
- d. \$800,000

1M85#46. Farr, Inc., is disposing of a segment of its business. At the measurement date the net loss from the disposal is estimated to be \$675,000. Included in this \$675,000 are severance pay of \$50,000 and employee relocation costs of \$25,000, both of which are directly associated with the decision to dispose of the segment, and estimated operating loss of the segment to the disposal date of \$100,000. A loss of \$125,000 from operations from the beginning of the year to the measurement date is not included in the \$675,000 estimated disposal loss. Ignoring income taxes, how much should be reported on Farr's income statement as the total loss under the heading "discontinued operations"?

- a. \$225,000
- b. \$625,000
- c. \$650,000
- d. \$800,000

1M85#48. Trent Company had net income of \$700,000 for the year ended December 31, 1984, after giving effect to the following events which occurred during the year:

- The decision was made January 2 to discontinue the plastics manufacturing segment.
- The plastics manufacturing segment was sold June 30.
- Operating loss from January 1 to June 30 for the plastics manufacturing segment amounted to \$60,000 before tax benefit.
- Plastics manufacturing equipment with a book value of \$350,000 was sold for \$200,000.

Trent's tax rate was 40% for 1984. For the year ended December 31, 1984, Trent's after-tax income from continuing operations was

- a. \$574,000
- b. \$700,000
- c. \$784,000
- d. \$826,000

E. Accounting Changes

1M89#52. On January 1, 1988, Roem Corp. changed its inventory method to FIFO from LIFO for both financial and income tax reporting purposes. The change resulted in a \$500,000 increase in the January 1, 1988 inventory. Assume that the income tax rate for all years is 30%. The cumulative effect of the accounting change should be reported by Roem in its 1988

- a. Retained earnings statement as a \$350,000 addition to the beginning balance.
- b. Income statement as a \$350,000 cumulative effect of accounting change.
- c. Retained earnings statement as a \$500,000 addition to the beginning balance.
- d. Income statement as a \$500,000 cumulative effect of accounting change.

1N87#51. On January 1, 1986, Farr, Inc. changed to the straight-line method of depreciation from an accelerated method of depreciation for its machinery and equipment. The accumulated depreciation through December 31, 1985, was \$600,000 higher than if the straight-line method had been used. The change was made for financial statement reporting but not for income tax reporting. Farr's income tax rate is 40% for 1985 and 1986. In Farr's 1986 income statement, the cumulative effect of this change in accounting principle should be reported at

- a. \$600,000
- b. \$360,000
- c. \$240,000
- d. \$0

1M87#47. On January 1, 1984, Bray Company purchased for \$240,000 a machine with a useful life of ten years and no salvage value. The machine was depreciated by the double declining balance method and the carrying amount of the machine was \$153,600 on December 31, 1985. Bray changed retroactively to the straight-line method on January 1, 1986. Bray can justify the change. What should be the depreciation expense on this machine for the year ended December 31, 1986?

- a. \$15,360
- b. \$19,200
- c. \$24,000
- d. \$30,720

2N86

Items 11 and 12 are based on the following data:

Ali Co. bought a machine on January 1, 1981, for \$24,000, at which time it had an estimated useful life of eight years, with no residual value. Straight-line de-

Selected Questions

preciation is used for all of Ali's depreciable assets. On January 1, 1983, the machine's estimated useful life was determined to be only six years from the acquisition date. Accordingly, the appropriate accounting change was made in 1983. The direct effects of this change were limited to the effect on depreciation and the related provision for income tax. Ali's income tax rate was 40% in all the affected years.

11. In Ali's 1983 financial statements, how much should be reported as the cumulative effect on prior years because of the change in the estimated useful life of the machine?

- a. \$0
- b. \$1,200
- c. \$2,000
- d. \$2,800

12. For the year ended December 31, 1985, how much depreciation expense should Ali record for this machine?

- a. \$0
- b. \$2,700
- c. \$4,500
- d. \$6,300

1M86#57. During 1985 Kerr Company determined that machinery previously depreciated over a seven-year life had a total estimated useful life of only five years. An accounting change was made in 1985 to reflect the change in estimate. If the change had been made in 1984, accumulated depreciation would have been \$800,000 at December 31, 1984, instead of \$600,000. As a result of this change, the 1985 depreciation expense was \$50,000 greater. The income tax rate was 40% in both years. What should be reported in Kerr's income statement for the year ended December 31, 1985, as the cumulative effect on prior years of changing the estimated useful life of the machinery?

- a. \$0
- b. \$120,000
- c. \$150,000
- d. \$200,000

1M86#58. On January 1, 1985, Poe Construction, Inc., changed to the percentage-of-completion method of income recognition for financial statement reporting but not for income tax reporting. Poe can justify this change in accounting principle. As of December 31, 1984, Poe compiled data showing that income under the completed contract method aggregated \$700,000. If the percentage-of-completion method had been used, the accumulated income through December 31, 1984, would have been \$880,000. Assuming an income tax rate of 40% for all years, the cumulative effect of this accounting change should be reported by Poe in the 1985

- a. Retained earnings statement as a \$180,000 credit adjustment to the beginning balance.
- b. Income statement as a \$180,000 credit.
- c. Retained earnings statement as a \$108,000 credit adjustment to the beginning balance.
- d. Income statement as a \$108,000 credit.

1N85#49. On January 2, 1982, Garr Company acquired machinery at a cost of \$320,000. This machinery was being depreciated by the double declining balance method over an estimated useful life of eight years, with no residual value. At the beginning of 1984, it was decided to change to the straight-line method of depreciation. Ignoring income tax considerations, the cumulative effect of this accounting change is

- a. \$0
- b. \$ 60,000
- c. \$ 65,000
- d. \$140,000

1N85#50. On January 1, 1984, Black Company changed its inventory cost flow method to FIFO from LIFO for both financial statement and income tax reporting purposes. The change resulted in a \$600,000 increase in the beginning inventory at January 1, 1984. Ignoring income taxes, the accounting change should be reported by Black in its 1984

- a. Income statement as a \$600,000 debit.
- b. Retained earnings statement as a \$600,000 debit adjustment to the beginning balance.
- c. Income statement as a \$600,000 credit.
- d. Retained earnings statement as a \$600,000 credit adjustment to the beginning balance.

1M85#28. On December 31, 1984, Holden, Inc., appropriately changed to the FIFO cost method from the weighted-average cost method for financial statement and income tax purposes. The change will result in a \$250,000 increase in the beginning inventory at January 1, 1984. Assuming a 40% income tax rate, the cumulative effect of this accounting change for the year ended December 31, 1984, is

- a. \$0
- b. \$100,000
- c. \$150,000
- d. \$250,000

1M85#49. Case Corporation purchased a machine on January 1, 1979, with an estimated useful life of ten years and no salvage. The machine was depreciated by the double declining balance method for both financial statement and income tax reporting. On January 1, 1984, Case changed to the straight-line method for financial statement reporting but not for income tax reporting. The accumulated depreciation from January 1, 1979, through December 31, 1983, was \$280,000. If the straight-line method had been used, the accumulated depreciation at December 31, 1983, would have been \$210,000. Case's effective income tax rate for the years 1979 through 1984 is 50%. The amount shown in the 1984 income statement for the cumulative effect of changing to the straight-line method would be

- a. \$70,000 debit.
- b. \$70,000 credit.
- c. \$35,000 credit.
- d. \$0.

F. Earnings Per Share

1N88#50. During 1987, Moore Corp. had the following two classes of stock issued and outstanding for the entire year:

- 100,000 shares of common stock, \$1 par.
- 1,000 shares of 4% preferred stock, \$100 par, convertible share for share into common stock. This stock is not a common stock equivalent.

Moore's 1987 net income was \$900,000, and its income tax rate for the year was 30%. In the computation of primary earnings per share for 1987, the amount to be used in the numerator is

- a. \$896,000
- b. \$898,800
- c. \$900,000
- d. \$901,200

1N88#57. On January 1, 1987, Apex Company, whose stock is publicly traded, had 100,000 shares of common stock issued and outstanding. On April 1, 1987, Apex issued a 10% stock dividend. The number of shares to be used in the computation of earnings per share for 1987 is

- a. 100,000
- b. 105,000
- c. 107,500
- d. 110,000

1N87#48. At December 31, 1985, Lex, Inc. had 600,000 shares of common stock outstanding. On April 1, 1986, an additional 180,000 shares of common stock were issued for cash. Lex also had \$5,000,000 of 8% convertible bonds outstanding at December 31, 1986, which are convertible into 150,000 shares of common stock. The bonds were considered common stock equivalents at the time of issuance and are dilutive in the 1986 earnings per share computation. No bonds were issued or converted into common stock during 1986. What is the number of shares that should be used in computing primary earnings per share for 1986?

- a. 735,000
- b. 780,000
- c. 885,000
- d. 930,000

1N87#52. Rand, Inc. had 20,000 shares of common stock outstanding at January 1, 1986. On May 1, 1986, it issued 10,500 shares of common stock. Outstanding all year were 10,000 shares of nonconvertible preferred stock on which a dividend of \$4 per share was paid in December 1986. Net income for 1986 was \$96,700. Rand's earnings per share for 1986 are

- a. \$1.86
- b. \$2.10
- c. \$2.84
- d. \$3.58

1M87#58. Dunn, Inc., had 200,000 shares of \$20 par common stock and 20,000 shares of \$100 par, 6%, cumulative, convertible preferred stock outstanding for the entire year ended December 31, 1986. The preferred stock was not a common stock equivalent at time of issue, and each share is convertible into five shares of common stock. Dunn's net income for 1986 was \$840,000. For the year ended December 31, 1986, the fully diluted earnings per share is

- a. \$2.40
- b. \$2.80
- c. \$3.60
- d. \$4.20

2M87

Items 4 through 11* are based on the following data:

The separate condensed balance sheets and income statements of Par Corp. and its wholly-owned subsidiary, Sub Corp., are as follows:

BALANCE SHEETS

December 31, 1986

	<u>Par</u>	<u>Sub</u>
<u>Assets</u>		
Current		
Cash	\$ 150,000	\$ 50,000
Accounts receivable (net)	190,000	60,000
Inventories	90,000	40,000
Total current assets	430,000	150,000
Property, plant, and equipment (net)	365,000	200,000
Investment in Sub (equity method)	315,000	—
Total assets	<u>\$1,110,000</u>	<u>\$350,000</u>

Liabilities and Stockholders' Equity

Current liabilities		
Accounts payable	\$ 100,000	\$ 60,000
Accrued liabilities	30,000	20,000
Total current liabilities	130,000	80,000
Stockholders' equity		
Common stock (\$10 par)	220,000	30,000
Additional paid-in capital	140,000	100,000
Retained earnings	620,000	140,000
Total stockholders' equity	980,000	270,000
Total liabilities and stockholders' equity	<u>\$1,110,000</u>	<u>\$350,000</u>

*The items omitted can be found in other Content Specification Groups.

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INCOME STATEMENTS
For the Year Ended December 31, 1986

	<u>Par</u>	<u>Sub</u>
Sales	\$1,000,000	\$300,000
Cost of goods sold	770,000	200,000
Gross margin	230,000	100,000
Other operating expenses	130,000	50,000
Operating income	100,000	50,000
Equity in earnings of Sub	25,000	—
Income before income taxes	125,000	50,000
Provision for income taxes	40,000	20,000
Net income	<u>\$ 85,000</u>	<u>\$ 30,000</u>

Additional information:

- On January 1, 1986, Par purchased for \$300,000 all of Sub's \$10 par, voting common stock. On January 1, 1986, the fair value of Sub's assets and liabilities equaled their carrying amount of \$330,000 and \$80,000, respectively. Par's policy is to amortize intangible assets over a 10-year period, unless a definite life is ascertainable.
- During 1986, Par and Sub paid cash dividends of \$50,000 and \$10,000, respectively. For tax purposes, Par receives the 100% exclusion for dividends received from Sub.
- There were no intercompany transactions except for Par's receipt of dividends from Sub, and Par's recording of its share of Sub's earnings.
- On June 30, 1986, Par issued 2,000 shares of common stock for \$17 per share. There were no other changes in either Par's or Sub's common stock during 1986.
- Both Par and Sub paid income taxes at the rate of 40%.

8. In computing the consolidated earnings per share for Par and its subsidiary, Sub, the number of shares used should be

- a. 25,000
- b. 24,000
- c. 22,000
- d. 21,000

2N86#17. At December 31, 1985 and 1984, Gow Corp. had 100,000 shares of common stock and 10,000

shares of 5%, \$100 par value cumulative preferred stock outstanding. No dividends were declared on either the preferred or common stock in 1985 or 1984. Net income for 1985 was \$1,000,000. For 1985, earnings per common share amounted to

- a. \$10.00
- b. \$ 9.50
- c. \$ 9.00
- d. \$ 5.00

2N86#18. Newt Corp. had earnings per share of \$12.00 for 1985, before taking any dilutive securities into consideration. No conversion or exercise of dilutive securities took place in 1985. However, possible conversion of convertible preferred stock, a common stock equivalent, would have reduced earnings per share to \$11.90. The effect of possible exercise of common stock warrants would have reduced earnings per share by an additional \$0.05. For 1985, what is the maximum amount that Newt may report as a single presentation of earnings per share?

- a. \$12.00
- b. \$11.95
- c. \$11.90
- d. \$11.85

1M86#51. On December 31, 1984, Case, Inc., had 300,000 shares of common stock issued and outstanding. Case issued a 10% stock dividend on July 1, 1985. On October 1, 1985, Case purchased 24,000 shares of its common stock for treasury, and recorded the purchase by the cost method. What is the number of shares that should be used in computing earnings per share for the year ended December 31, 1985?

- a. 306,000
- b. 309,000
- c. 324,000
- d. 330,000

1M86#52. Rhan Company had 200,000 shares of common stock issued and outstanding at December 31, 1984. No common stock was issued during 1985. On January 1, 1985, Rhan issued 50,000 shares of convertible preferred stock. This stock is convertible into 100,000 shares of common stock, and is not considered a common stock equivalent. During 1985, Rhan paid \$300,000 cash dividends on the preferred stock. Net income for the year ended December 31, 1985, was \$750,000. What should be Rhan's primary earnings per share for 1985?

- a. \$1.50
- b. \$2.25
- c. \$2.50
- d. \$3.75

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1N85

Items 54 and 55 are based on the following data:

Information relating to the capital structure of Parke Corporation is as follows:

	<i>December 31</i>	
	<u>1983</u>	<u>1984</u>
Outstanding shares of:		
Common stock	90,000	90,000
Preferred stock, convertible into 30,000 shares of common	30,000	30,000
10% convertible bonds, convertible into 20,000 shares of common	\$1,000,000	\$1,000,000

During 1984, Parke paid \$45,000 dividends on the preferred stock, which is considered a common stock equivalent. The convertible bonds are not considered common stock equivalents. Parke's net income for 1984 was \$980,000 and the income tax rate was 40%.

54. For the year ended December 31, 1984, the primary earnings per share is

- a. \$10.89
- b. \$10.39
- c. \$ 8.17
- d. \$ 7.79

55. For the year ended December 31, 1984, the fully diluted earnings per share is

- a. \$9.82
- b. \$8.29
- c. \$7.71
- d. \$7.43

1M85#51. Mann, Inc., had 300,000 shares of common stock issued and outstanding at December 31, 1983. On July 1, 1984, an additional 50,000 shares of common stock were issued for cash. Mann also had unexercised stock options to purchase 40,000 shares of common stock at \$15 per share outstanding at the beginning and end of 1984. The average market price of Mann's common stock was \$20 during 1984. What is the number of shares that should be used in computing primary earnings per share for the year ended December 31, 1984?

- a. 325,000
- b. 335,000
- c. 360,000
- d. 365,000

VI. Other Financial Topics

A. Disclosures in Notes to the Financial Statements

2M89#16. In March 1988, an explosion occurred at Nilo Co.'s plant, causing damage to area properties. By May 1988, no claims had yet been asserted against Nilo. However, Nilo's management and legal counsel concluded that it was reasonably possible that Nilo would be held responsible for negligence, and that \$3,000,000 would be a reasonable estimate of the damages. Nilo's \$5,000,000 comprehensive public liability policy contains a \$300,000 deductible clause. In Nilo's December 31, 1987 financial statements, for which the auditor's fieldwork was completed in April 1988, how should this casualty be reported?

- a. As a footnote disclosing a possible liability of \$3,000,000.
- b. As an accrued liability of \$300,000.
- c. As a footnote disclosing a possible liability of \$300,000.
- d. No footnote disclosure or accrual is required for 1987 because the event occurred in 1988.

1N88#51. During 1987, Jones Company engaged in the following transactions:

- Salary expense to key employees who are also principal owners \$100,000
- Sales to affiliated enterprises 250,000

Which of the two transactions would be disclosed as related party transactions in Jones's 1987 financial statements?

- a. Neither transaction.
- b. The \$100,000 transaction only.
- c. The \$250,000 transaction only.
- d. Both transactions.

1M88#46. A personal injury liability suit for \$500,000 was brought against Ashe Corp. during 1987. Ashe's management and counsel concluded that it is reasonably possible that Ashe will be responsible for damages, and that \$150,000 is a reasonable estimate of the dam-

Selected Questions

ages. In Ashe's December 31, 1987 financial statements, how should this item be reported?

- No disclosure in the financial statements or accrual is required.
- As an accrued liability of \$50,000 and as a disclosure in the financial statements indicating the exposure to an additional amount of loss up to \$350,000.
- As an accrued liability of \$150,000 only.
- As a disclosure only in the financial statements indicating the possible loss of \$150,000.

C. Nonmonetary Transactions

1M88#50. On March 31, 1988, Winn Company traded in an old machine having a carrying amount of \$16,800, and paid a cash difference of \$6,000 for a new machine having a total cash price of \$20,500. On March 31, 1988, what amount of loss should Winn recognize on this exchange?

- \$0
- \$2,300
- \$3,700
- \$6,000

2M87#18. On September 1, 1986, Ron Corp. issued 1,000 shares of its \$25 par treasury common stock for a parcel of land to be held for a future plant site. The treasury shares were acquired by Ron at a cost of \$30 per share. Ron's common stock had a fair market value of \$40 per share on September 1, 1986. Ron received \$5,000 from the sale of scrap when an existing structure on the site was razed. At what amount should the land be carried?

- \$40,000
- \$35,000
- \$30,000
- \$25,000

1N86#52. On December 2, 1985, Parr Company traded in a used delivery truck with a carrying amount of \$5,400 for a new delivery truck having a list price of \$16,000, and paid a cash difference of \$7,500 to the dealer. The used truck had a fair value of \$6,000 on the date of the exchange.

At what amount should the new truck be recorded on Parr's books?

- \$10,600
- \$12,900
- \$13,500
- \$16,000

1N86#53. Caine Motor Sales exchanged a car from its inventory for a computer to be used as a long-term

asset. The following information relates to this exchange that took place on July 31, 1986:

Carrying amount of the car	\$30,000
Listed selling price of the car	45,000
Fair value of the computer	43,000
Cash difference paid by Caine	5,000

On July 31, 1986, what amount of profit should Caine recognize on this exchange?

- \$0
- \$ 8,000
- \$10,000
- \$13,000

2M86#11. Clay Township owned an idle parcel of real estate consisting of land and a factory building. Clay gave title to this realty to Wolf Co. as an incentive for Wolf to establish manufacturing operations in the Township. Wolf paid nothing for this realty, which had a fair market value of \$200,000 at the date of the grant. Wolf should record this nonmonetary transaction as a

- Memo entry only.
- Credit to retained earnings for \$200,000.
- Credit to extraordinary income for \$200,000.
- Credit to additional paid-in capital for \$200,000.

1N85#41. In October 1984, Allen Company exchanged a used packaging machine, having a book value of \$120,000, for a dissimilar new machine and paid a cash difference of \$15,000. The market value of the used packaging machine was determined to be \$140,000. In its income statement for the year ended December 31, 1984, how much gain should Allen recognize on this exchange?

- \$0
- \$ 5,000
- \$15,000
- \$20,000

1M85#52. In January 1984 Bell Company exchanged an old machine, with a book value of \$39,000 and a fair value of \$35,000, and paid \$10,000 cash for a similar used machine having a list price of \$50,000. At what amount should the machine acquired in the exchange be recorded on the books of Bell?

- \$45,000
- \$46,000
- \$49,000
- \$50,000

D. Interim Financial Statements

2M89#12. Vilo Corp. has estimated that total depreciation expense for the year ending December 31, 1989 will amount to \$60,000, and that 1989 year-end bonuses

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to employees will total \$120,000. In Vilo's interim income statement for the six months ended June 30, 1989, what is the total amount of expense relating to these two items that should be reported?

- a. \$0
- b. \$ 30,000
- c. \$ 90,000
- d. \$180,000

1N88#46. During the second quarter of 1988, Buzz Company sold a piece of equipment at a \$12,000 gain. What portion of the gain should Buzz report in its income statement for the second quarter of 1988?

- a. \$12,000
- b. \$ 6,000
- c. \$ 4,000
- d. \$0

1M88#54. On March 15, 1987, Rex Company paid property taxes of \$180,000 on its factory building for calendar year 1987. On April 1, 1987, Rex made \$300,000 in unanticipated repairs to its plant equipment. The repairs will benefit operations for the remainder of the calendar year. What total amount of these expenses should be included in Rex's quarterly income statement for the three months ended June 30, 1987?

- a. \$ 75,000
- b. \$145,000
- c. \$195,000
- d. \$345,000

1N87#53. Dean Company uses the retail inventory method to estimate its inventory for interim statement purposes. Data relating to the computation of the inventory at July 31, 1987, are as follows:

	<u>Cost</u>	<u>Retail</u>
Inventory, 2/1/87	\$ 180,000	\$ 250,000
Purchases	1,020,000	1,575,000
Markups, net		175,000
Sales		1,705,000
Estimated normal shoplifting losses		20,000
Markdowns, net		125,000

Under the approximate lower of average cost or market retail method, Dean's estimated inventory at July 31, 1987 is

- a. \$ 90,000
- b. \$ 96,000
- c. \$102,000
- d. \$150,000

2M87#12. In January 1987, Noll Corp. paid property taxes of \$20,000 covering the calendar year 1987. Also in January 1987, Noll estimated that its year-end bonuses to factory workers would amount to \$80,000 for 1987. In Noll's quarterly income statement for the three

months ended March 31, 1987, what is the total amount of expense relating to these two items that should be reported?

- a. \$25,000
- b. \$20,000
- c. \$ 5,000
- d. \$0

1N86#54. In January 1986, Pine Company paid property taxes of \$80,000 covering the calendar year 1986. Also in January 1986 Pine estimated that its year-end bonuses to executives would amount to \$320,000 for 1986. What is the total amount of expense relating to these two items that should be reflected in Pine's quarterly income statement for the three months ended June 30, 1986?

- a. \$100,000
- b. \$ 80,000
- c. \$ 20,000
- d. \$0

2M86#12. On July 1, 1985, Dolan Corp. incurred an extraordinary loss of \$300,000, net of income tax saving. Dolan's operating income for the full year ending December 31, 1985, was expected to be \$500,000. In Dolan's income statement for the quarter ended September 30, 1985, how much of this extraordinary loss should be disclosed separately?

- a. \$300,000
- b. \$150,000
- c. \$ 75,000
- d. \$0

1N85#45. An inventory loss from market decline of \$900,000 occurred in May 1984. Kerr Company recorded this loss in May 1984 after its March 31, 1984, quarterly income statement was issued. None of this loss was recovered by the end of 1984. How much of the inventory loss should be recognized in Kerr's quarterly income statement for the three months ended December 31, 1984?

- a. \$0
- b. \$225,000
- c. \$300,000
- d. \$900,000

1M85#47. An inventory loss from market decline of \$720,000 occurred in May 1984. King Company appropriately recorded this loss in May 1984 after its March 31, 1984, quarterly report was issued. How much of the inventory loss should be reflected in King's quarterly income statement for the three months ended June 30, 1984?

- a. \$720,000
- b. \$360,000
- c. \$180,000
- d. \$0

1M85#53. The first week of January 1984 Bolton Company made unanticipated repairs to its plant equipment at a cost of \$240,000. These repairs will benefit

Selected Questions

operations for the remainder of the calendar year. On March 15, 1984, Bolton paid property taxes of \$120,000 on its factory building for calendar year 1984. What total amount of these expenses should be included in Bolton's quarterly income statement for the three months ended March 31, 1984?

- a. \$ 90,000
- b. \$180,000
- c. \$270,000
- d. \$360,000

E. Historical Cost, Constant Dollar Accounting, and Current Cost

2M89#13. The following items were among those that appeared on Rubi Co.'s books at the end of 1988:

Merchandise inventory	\$600,000
Loans to employees	20,000

What amount should Rubi classify as monetary assets in preparing constant dollar financial statements?

- a. \$0
- b. \$ 20,000
- c. \$600,000
- d. \$620,000

1N88#52. At December 31, 1987, Jannis Corp. owned two assets as follows:

	<u>Equipment</u>	<u>Inventory</u>
Current cost	\$100,000	\$80,000
Recoverable amount	\$ 95,000	\$90,000

Jannis voluntarily disclosed supplementary information about current cost at December 31, 1987. In such a disclosure, at what amount would Jannis report total assets?

- a. \$175,000
- b. \$180,000
- c. \$185,000
- d. \$190,000

1M88#55. Bart Corp.'s accounting records had the following data relating to cost of goods sold for 1987:

	<u>Amount</u>	<u>Units</u>
Inventory, 1/1/87	\$ 530,000	20,000
Production during 1987	2,790,000	90,000
	3,320,000	110,000
Inventory, 12/31/87	945,000	30,000
Cost of goods sold	<u>\$2,375,000</u>	<u>80,000</u>

The current cost per inventory unit was \$30 at January 1, 1987, and \$36 at December 31, 1987. In Bart's voluntary supplementary information for 1987, the cost of goods sold restated into average current cost would be

- a. \$2,490,000
- b. \$2,520,000
- c. \$2,580,000
- d. \$2,640,000

1N87

Items 54 and 55 are based on the following data:

Rice Wholesaling Corp. accounts for inventory on a FIFO basis. There were 8,000 units in inventory on January 1, 1986. Costs were incurred and goods purchased as follows during 1986:

	<u>Historical costs</u>	<u>Units purchased</u>	<u>Units sold</u>
1986			
1st quarter	\$ 410,000	7,000	7,500
2nd quarter	550,000	8,500	7,300
3rd quarter	425,000	6,500	8,200
4th quarter	630,000	9,000	7,000
	<u>\$2,015,000</u>	<u>31,000</u>	<u>30,000</u>

Rice estimates that the current cost per unit of inventory was \$57 at January 1, 1986, and \$71 at December 31, 1986.

54. In Rice's voluntary supplementary information restated into current cost, the December 31, 1986 inventory should be reported at

- a. \$576,000
- b. \$585,000
- c. \$630,000
- d. \$639,000

55. In Rice's voluntary supplementary information restated into current cost, the cost of goods sold for 1986 would be

- a. \$1,920,000
- b. \$1,944,000
- c. \$2,100,000
- d. \$2,130,000

1M87#57. Details of Poe Corp.'s plant assets at December 31, 1986, are as follows:

<u>Year acquired</u>	<u>Percent depreciated</u>	<u>Historical cost</u>	<u>Estimated current cost</u>
1984	30	\$200,000	\$280,000
1985	20	60,000	76,000
1986	10	80,000	88,000

Poe calculates depreciation at 10% per annum, using the straight-line method. A full year's depreciation is charged in the year of acquisition. There were no disposals of plant assets. In Poe's voluntary supplementary information restated into current cost, the net current cost (after accumulated depreciation) of the plant assets at December 31, 1986, should be stated as

- a. \$364,000
- b. \$336,000
- c. \$260,000
- d. \$232,000

1N86#60. Kerr Company purchased a machine for \$115,000 on January 1, 1985, the company's first day of operations. At the end of the year, the current cost

Accounting Practice

of the machine was \$125,000. The machine has no salvage value, a five-year life, and is depreciated by the straight line method. For the year ended December 31, 1985, the amount of the current cost depreciation expense which would appear in supplementary current cost financial statements is:

- a. \$14,000
- b. \$23,000
- c. \$24,000
- d. \$25,000

2M86#1. At both the beginning and end of the year, Lang Co.'s monetary assets exceeded monetary liabilities by \$3,000,000. On January 1, the general price level was 125. On December 31, the general price level was 150. How much was Lang's purchasing power loss on net monetary items during the year?

- a. \$0
- b. \$ 600,000
- c. \$ 750,000
- d. \$1,125,000

2M86#10. The following items were among those that appeared on Roth Co.'s books at the beginning and end of the year:

Demand bank deposits	\$500,000
Net long-term receivables	300,000
Deferred income tax charges	100,000

In preparing constant dollar financial statements, how much should Roth classify as monetary assets?

- a. \$500,000
- b. \$600,000
- c. \$800,000
- d. \$900,000

1N85#51. Lewis Company was formed on January 1, 1983. Selected balances from the historical cost balance sheet at December 31, 1984, were as follows:

Land (purchased in 1983)	\$120,000
Investment in nonconvertible bonds (purchased in 1983, and expected to be held to maturity)	60,000
Long-term debt	80,000

The average Consumer Price Index was 100 for 1983, and 110 for 1984. In a supplementary constant dollar balance sheet (adjusted for changing prices) at December 31, 1984, these selected account balances should be shown at

	<u>Land</u>	<u>Investment</u>	<u>Long-term debt</u>
a.	\$120,000	\$60,000	\$88,000
b.	\$120,000	\$66,000	\$88,000
c.	\$132,000	\$60,000	\$80,000
d.	\$132,000	\$66,000	\$80,000

1M85#54. Information with respect to Wilson Company's cost of goods sold for 1984 is as follows:

	<u>Historical cost</u>	<u>Units</u>
Inventory, 1/1/84	\$1,060,000	20,000
Production during 1984	5,580,000	90,000
	6,640,000	110,000
Inventory, 12/31/84	1,890,000	30,000
Cost of goods sold	<u>\$4,750,000</u>	<u>80,000</u>

Wilson estimates that the current cost per unit of inventory was \$58 at January 1, 1984, and \$72 at December 31, 1984. In Wilson's supplementary information restated into average current cost, the cost of goods sold for 1984 should be

- a. \$4,640,000
- b. \$5,040,000
- c. \$5,200,000
- d. \$5,760,000

F. Gain Contingencies

1N88#53. In October 1987, Swine Corp. filed a lawsuit seeking \$100,000 in damages for alleged copyright infringement. On December 31, 1987, with the case still in progress, Swine's attorney asserted that Swine would probably win the suit, but would likely receive \$80,000 in damages. On February 1, 1988, before Swine's 1987 financial statements were issued, the suit was settled out of court for \$60,000. In its December 31, 1987 financial statements, Swine should report accrued revenue of

- a. \$0
- b. \$ 60,000
- c. \$ 80,000
- d. \$100,000

1M88#56. For the year ended December 31, 1987, Colt Corp. has a loss carryforward of \$180,000 available to offset future taxable income. At December 31, 1987, realization of the tax benefit of the carryforward is probable, but not assured beyond any reasonable doubt. Assume an income tax rate of 30%. What amount of the tax benefit should be reported in Colt's 1987 income statement?

- a. \$180,000
- b. \$126,000
- c. \$ 54,000
- d. \$0

1N86#51. Kay Company is preparing its December 31, 1985, financial statements and must determine the proper accounting treatment for the following situations:

- On December 30, 1985, Kay received a \$200,000 offer for its ROGO patent. Kay's management is considering whether or not to

Selected Questions

sell the patent. The offer expires on February 28, 1986. The patent has a carrying amount of \$130,000 at December 31, 1985.

- On December 31, 1985, Kay, as lessee under an operating lease, sublet a building for a three-year period at \$150,000 annual rental. Kay's annual rental expense for the same period will be \$110,000.

Assume an income tax rate of 40%. In its 1985 income statement, Kay should recognize increased net income of

- a. \$0
- b. \$66,000
- c. \$70,000
- d. \$72,000

1N85#52. At December 31, 1984, Dorr, Inc., has a net operating loss carryforward of \$90,000 available to offset future taxable income. At this date, the realization of the tax benefit of the carryforward is probable, but not assured beyond any reasonable doubt. Assuming an income tax rate of 40%, what amount of the potential carryforward tax benefit should be reported in the income statement for the year ended December 31, 1984?

- a. \$0
- b. \$36,000
- c. \$54,000
- d. \$90,000

1N85#58. In May 1981 West Company filed suit against Brown, Inc., seeking \$850,000 damages for patent infringement. A court verdict in November 1984 awarded West \$600,000 in damages, but Brown's appeal is not expected to be decided before 1986. West's counsel believes it is probable that West will be successful against Brown for an estimated amount in the range between \$300,000 and \$450,000, with \$400,000 considered the most likely amount. What amount should West record as income from lawsuit in the year ended December 31, 1984?

- a. \$0
- b. \$300,000
- c. \$400,000
- d. \$600,000

G. Segments and Lines of Business

1N87#59. Cord Corporation discloses supplementary industry segment information for its two reportable segments. Data for 1986 are available as follows:

	<u>Segment E</u>	<u>Segment W</u>
Sales	\$750,000	\$250,000
Traceable operating expenses	325,000	130,000

Additional 1986 expenses are as follows:

Indirect operating expenses	\$120,000
General corporate expenses	100,000

Appropriately selected common expenses are allocated to segments based on the ratio of each segment's sales to total sales. The 1986 operating profit for segment E was

- a. \$260,000
- b. \$335,000
- c. \$395,000
- d. \$425,000

1M87#56. Clay Company has three lines of business, each of which was determined to be a reportable segment. Company sales aggregated \$1,500,000 in 1986, of which Segment No. 1 contributed 40%. Traceable costs were \$350,000 for Segment No. 1 out of a total of \$1,000,000 for the company as a whole. For internal reporting, Clay allocates common costs of \$300,000 based on the ratio of a segment's income before common costs to the total income before common costs. In its 1986 financial statements, how much should Clay report as operating profit for Segment No. 1?

- a. \$250,000
- b. \$200,000
- c. \$130,000
- d. \$100,000

1N86#55. Colt Company has four manufacturing divisions, each of which has been determined to be a reportable segment. Common operating costs are appropriately allocated on the basis of each division's sales in relation to Colt's aggregate sales. Colt's Delta division accounted for 40% of Colt's total sales in 1985. For the year ended December 31, 1985, Delta had sales of \$2,000,000 and traceable operating costs of \$1,200,000. In 1985 Colt incurred operating costs of \$200,000 that were not directly traceable to any of the divisions. In addition, Colt incurred interest expense of \$160,000 in 1985. In reporting supplementary segment information, how much should be shown as Delta's operating profit for 1985?

- a. \$800,000
- b. \$750,000
- c. \$720,000
- d. \$656,000

2M86#2. The following information pertains to Hay Corp. and its divisions for the year ended December 31, 1985:

Sales to unaffiliated customers	\$1,000,000
Intersegment sales of products similar to those sold to unaffiliated customers	300,000
Interest earned on loans to mother industry segments	20,000

Hay and all of its divisions are engaged solely in manufacturing operations. Hay has a reportable segment if that segment's revenue exceeds

- a. \$100,000
- b. \$102,000
- c. \$130,000
- d. \$132,000

Accounting Practice

1N85#59. Evan, Inc., discloses supplemental industry segment information. The following data are available for 1984:

<u>Segment</u>	<u>Sales</u>	<u>Traceable operating expenses</u>
E	\$ 500,000	\$300,000
F	400,000	250,000
G	300,000	175,000
	<u>\$1,200,000</u>	<u>\$725,000</u>

Additional 1984 expenses, not included above, are as follows:

Indirect operating expenses	\$180,000
General corporate expenses	120,000

Appropriate common expenses are allocated to segments based on the ratio of a segment's sales to total sales. What should be the operating profit for segment G for 1984?

- a. \$125,000
- b. \$ 80,000
- c. \$ 65,000
- d. \$ 50,000

1M85#55. Mill, Inc., reports operating profit as to industry segments in its supplementary financial information annually. The following data are available for 1984:

<u>Segment</u>	<u>Sales</u>	<u>Traceable costs</u>
A	\$1,500,000	\$ 900,000
B	1,000,000	450,000
C	500,000	250,000
	<u>\$3,000,000</u>	<u>\$1,600,000</u>

Additional expenses not included above are as follows:

Indirect operating expenses	\$480,000
General corporate expenses	300,000
Other expense (net)	96,000

Mill allocates common costs based on the ratio of a segment's sales to total sales. What should be the operating profit for segment A for 1984?

- a. \$162,000
- b. \$210,000
- c. \$312,000
- d. \$360,000

H. Employee Benefits

2M89#18. On May 1, 1988, Gray Corp. granted stock options to certain key employees as additional compensation. The options were for 1,000 shares of Gray's \$1 par value common stock at an option price of \$30 per share. The market price of this stock on May 1,

1988 was \$40 per share. The options were exercisable beginning January 2, 1989 and expire on December 31, 1990. On March 1, 1989, when Gray's stock was trading at \$42 per share, all the options were exercised. The total amount of pretax compensation that Gray should record for 1988 is

- a. \$ 1,000
- b. \$ 5,000
- c. \$10,000
- d. \$12,000

2M89#19. Ral Corp. has an incentive compensation plan under which a branch manager receives 10% of the branch's income after deduction of the bonus but before deduction of income tax. Branch income for 1988 before the bonus and income tax was \$165,000. The tax rate was 30%. The 1988 bonus amounted to

- a. \$12,600
- b. \$15,000
- c. \$16,500
- d. \$18,000

1N88#54. The following information relates to the 1987 activity of the defined benefit pension plan of Lindy Corp., a company whose stock is publicly traded:

Service cost	\$150,000
Return on plan assets	40,000
Interest cost on pension benefit obligation	82,000
Amortization of actuarial loss	15,000
Amortization of unrecognized net obligation	35,000

Lindy's 1987 pension cost is

- a. \$322,000
- b. \$287,000
- c. \$242,000
- d. \$158,000

1N87

Items 56 and 57 are based on the following data:

On January 1, 1986, Fay Corporation established an employee stock ownership plan (ESOP). Selected transactions relating to the ESOP during 1986 were as follows:

- April 1, 1986, Fay contributed \$30,000 cash and 3,000 shares of its \$10 par common stock to the ESOP. On this date the market price of the stock was \$18 a share.
- On October 1, 1986, the ESOP borrowed \$100,000 from Union National Bank and acquired 5,000 shares of Fay's common stock in the open market at \$17 a share. The note is for one year, bears interest at 10%, and is guaranteed by Fay.
- On December 15, 1986, the ESOP distributed 6,000 shares of Fay common stock to employees of Fay in accordance with the plan formula.

Selected Questions

56. In its 1986 income statement, how much should Fay report as compensation expense relating to the ESOP?

- a. \$184,000
- b. \$120,000
- c. \$ 84,000
- d. \$ 60,000

57. In Fay's December 31, 1986 balance sheet, how much should be reported as a reduction of shareholders' equity and as an endorsed note payable in respect of the ESOP?

	<i>Reduction of shareholders' equity</i>	<i>Endorsed note payable</i>
a.	\$0	\$0
b.	\$0	\$100,000
c.	\$100,000	\$0
d.	\$100,000	\$100,000

1M87#50. Ruhl Company grants all employees two weeks paid vacation for each full year of employment. Unused vacation time can be accumulated and carried forward to succeeding years, and will be paid at the salaries in effect when vacations are taken or when employment is terminated. There was no employee turnover in 1986. Additional information relating to the year ended December 31, 1986, is as follows:

Liability for accumulated vacations at 12/31/85	\$25,000
Pre-1986 accrued vacations taken from 1/1/86 to 9/30/86 (the authorized period for vacations)	15,000
Vacations earned for work in 1986 (adjusted to current rates)	20,000

Ruhl granted a 10% salary increase to all employees on October 1, 1986, its annual salary increase date. For the year ended December 31, 1986, Ruhl should report vacation pay expense of

- a. \$21,000
- b. \$22,500
- c. \$30,000
- d. \$35,000

1N85#53. Mann, Inc., has a bonus plan covering all employees. The total bonus is equal to 10% of Mann's preliminary (prebonus, pretax) income reduced by the income tax (computed on the preliminary income less the bonus itself). Mann's preliminary income for 1984 is \$200,000 and the income tax rate is 40%. How much is the bonus for 1984?

- a. \$10,800
- b. \$12,000
- c. \$12,500
- d. \$20,000

I. Analysis of Financial Statements

2M89

Items 14 and 15 are based on the following:

Rey, Inc. Selected Financial Data December 31,

	1988	1987
Cash	\$ 170,000	\$ 90,000
Accounts receivable (net)	450,000	400,000
Merchandise inventory	540,000	420,000
Short-term marketable securities	80,000	40,000
Land and building (net)	1,000,000	1,000,000
Mortgage payable — current portion	60,000	50,000
Accounts payable and accrued liabilities	240,000	220,000
Short-term notes payable	100,000	140,000

Net credit sales totaled \$3,000,000 and \$2,000,000 for the years ended December 31, 1988 and 1987, respectively.

14. At December 31, 1988, Rey's quick (acid test) ratio was

- a. 1.50 to 1.
- b. 1.75 to 1.
- c. 2.06 to 1.
- d. 3.10 to 1.

15. For 1988, Rey's accounts receivable turnover was

- a. 1.13
- b. 1.50
- c. 6.67
- d. 7.06

1N88#49. The following information is available from Timber Corp.'s financial records for 1987:

<u>Sales</u>	
Net credit sales	\$500,000
Net cash sales	250,000
	<u>\$750,000</u>

Accounts Receivable

Balance, January 1, 1987	\$ 75,000
Balance, December 31, 1987	50,000

How many times did Timber's accounts receivable turn over in 1987?

- a. 15
- b. 12
- c. 10
- d. 8

Accounting Practice

1M88#57. Selected information for Cain Corp. for the year ended December 31, 1987 follows:

Average days' sales in inventories	124
Average days' sales in accounts receivable	48

The average number of days in the operating cycle for 1987 was

- 172
- 124
- 86
- 76

1N87#58. Flax Company's accounting records disclosed the following information as of and for the year ended December 31, 1986:

Net credit sales	\$3,150,000
Net cash sales	630,000
Accounts receivable at beginning	500,000
Accounts receivable at end	900,000

Flax's accounts receivable turnover is

- 5.4 times.
- 4.5 times.
- 4.2 times.
- 3.5 times.

1N87#60. On December 31, 1985 and 1986, Taft Corporation had 100,000 shares of common stock and 50,000 shares of noncumulative and nonconvertible preferred stock issued and outstanding. Additional information is as follows:

Stockholders' equity at 12/31/86	\$4,500,000
Net income year ended 12/31/86	1,200,000
Dividends on preferred stock year ended 12/31/86	300,000
Market price per share of common stock at 12/31/86	72

The price-earnings ratio on common stock at December 31, 1986 was

- 5 to 1.
- 6 to 1.
- 8 to 1.
- 9 to 1.

1M87

Items 54 and 55 are based on the following data:

Drew Company Selected Financial Data

	As of December 31,	
	1986	1985
Cash	\$ 75,000	\$ 35,000
Accounts receivable (net)	225,000	200,000
Merchandise inventory	270,000	210,000

As of December 31,

	1986	1985
Short-term marketable securities	40,000	20,000
Land and building (net)	500,000	500,000
Mortgage payable-current portion	30,000	25,000
Accounts payable and accrued liabilities	120,000	110,000
Short-term notes payable	50,000	70,000

Year Ended December 31,

	1986	1985
Sales	\$1,500,000	\$1,300,000
Cost of goods sold	900,000	800,000

54. Drew's quick (acid test) ratio as of December 31, 1986, is

- 3.6 to 1.
- 3.1 to 1.
- 2.0 to 1.
- 1.7 to 1.

55. Based on a business year consisting of 300 days, what was the number of days' sales in average inventory for 1986?

- 80
- 70
- 54
- 48

2M87

Items 4 through 11* are based on the following data:

The separate condensed balance sheets and income statements of Par Corp. and its wholly-owned subsidiary, Sub Corp., are as follows:

BALANCE SHEETS December 31, 1986

	Par	Sub
<u>Assets</u>		
Current		
Cash	\$ 150,000	\$ 50,000
Accounts receivable (net)	190,000	60,000
Inventories	90,000	40,000
Total current assets	430,000	150,000
Property, plant, and equipment (net)	365,000	200,000
Investment in Sub (equity method)	315,000	—
Total assets	<u>\$1,110,000</u>	<u>\$350,000</u>

*The items omitted can be found in other Content Specification Groups.

Selected Questions

Liabilities and Stockholders' Equity

Current liabilities		
Accounts payable	\$ 100,000	\$ 60,000
Accrued liabilities	30,000	20,000
Total current liabilities	<u>130,000</u>	<u>80,000</u>
Stockholders' equity		
Common stock (\$10 par)	220,000	30,000
Additional paid-in capital	140,000	100,000
Retained earnings	620,000	140,000
Total stockholders' equity	<u>980,000</u>	<u>270,000</u>
Total liabilities and stockholders' equity	<u><u>\$1,110,000</u></u>	<u><u>\$350,000</u></u>

- There were no intercompany transactions except for Par's receipt of dividends from Sub, and Par's recording of its share of Sub's earnings.
 - On June 30, 1986, Par issued 2,000 shares of common stock for \$17 per share. There were no other changes in either Par's or Sub's common stock during 1986.
 - Both Par and Sub paid income taxes at the rate of 40%.
10. Par's January 1, 1986 inventory was \$110,000. Par's (parent only) 1986 inventory turnover ratio was
- 11.1
 - 10.0
 - 7.7
 - 7.0

1N86

Items 56 and 57 are based on the following data:

INCOME STATEMENTS For the Year Ended December 31, 1986

	<u>Par</u>	<u>Sub</u>
Sales	\$1,000,000	\$300,000
Cost of goods sold	770,000	200,000
Gross margin	230,000	100,000
Other operating expenses	130,000	50,000
Operating income	100,000	50,000
Equity in earnings of Sub	25,000	—
Income before income taxes	125,000	50,000
Provision for income taxes	40,000	20,000
Net income	<u><u>\$ 85,000</u></u>	<u><u>\$ 30,000</u></u>

Additional information:

- On January 1, 1986, Par purchased for \$300,000 all of Sub's \$10 par, voting common stock. On January 1, 1986, the fair value of Sub's assets and liabilities equaled their carrying amount of \$330,000 and \$80,000, respectively. Par's policy is to amortize intangible assets over a 10-year period, unless a definite life is ascertainable.
- During 1986, Par and Sub paid cash dividends of \$50,000 and \$10,000, respectively. For tax purposes, Par receives the 100% exclusion for dividends received from Sub.

Apex Corporation SELECTED FINANCIAL DATA Year Ended December 31, 1985

Operating income	\$900,000
Interest expense	<u>100,000</u>
Income before income tax	800,000
Income tax expense	<u>320,000</u>
Net income	480,000
Preferred stock dividends	<u>200,000</u>
Net income available to common stockholders	<u><u>\$280,000</u></u>
Common stock dividends	\$120,000

56. The times interest earned ratio is
- 2.8 to 1.
 - 4.8 to 1.
 - 8.0 to 1.
 - 9.0 to 1.
57. The times preferred dividend earned ratio is
- 1.4 to 1.
 - 1.7 to 1.
 - 2.4 to 1.
 - 4.0 to 1.

1N86#59. During 1985, Dunn Company purchased \$1,920,000 of inventory. The cost of goods sold for 1985 was \$1,800,000 and the ending inventory at December 31, 1985, was \$360,000. What was the inventory turnover for 1985?

- 5.0
- 5.3
- 6.0
- 6.4

Accounting Practice

2M86

Items 4 through 6 are based on the following data pertaining to Fox Co. for the calendar year 1985:

Sales (all on credit)	\$2,000,000	
Gross profit on sales	900,000	
Net income	150,000	
Purchases	1,000,000	
Inventory at end of year	200,000	
Accounts receivable at beginning of year	600,000	
Accounts receivable at end of year	400,000	
Stockholders' equity at end of year:		
Common stock outstanding (unchanged during year) —		
300,000 shares at par		
of \$1 per share	\$300,000	
Retained earnings	<u>500,000</u>	800,000

Dividends paid during the year totaled \$0.25 per share. The market price per share of Fox's stock was \$5 at the end of the year.

4. Fox's inventory turnover for 1985 was
 - a. 2.0 times.
 - b. 2.2 times.
 - c. 4.4 times.
 - d. 5.0 times.
5. Fox's accounts receivable turnover for 1985 was
 - a. 1.8 times.
 - b. 2.0 times.
 - c. 4.0 times.
 - d. 5.0 times.
6. The price-earnings ratio on Fox's common stock at the end of the year was
 - a. 2.0 to 1.
 - b. 2.5 to 1.
 - c. 10.0 to 1.
 - d. 20.0 to 1.

1M85#60. Selected information from the accounting records of Kay Company is as follows:

Net sales for 1984	\$1,800,000
Cost of goods sold for 1984	1,200,000
Inventory at 12/31/83	360,000
Inventory at 12/31/84	312,000

Kay's inventory turnover for 1984 is

- a. 3.57 times.
- b. 3.85 times.
- c. 5.36 times.
- d. 5.77 times.

1M85#59. At December 31, 1983, Mason, Inc., had 100,000 shares of \$10 par value common stock issued and outstanding. There was no change in the number of shares outstanding during 1984. Total stockholders' equity at December 31, 1984, was \$2,800,000. The net

income for the year ended December 31, 1984, was \$800,000. During 1984 Mason paid \$3 per share in dividends on its common stock. The quoted market value of Mason's common stock was \$48 per share on December 31, 1984. What was the price-earnings ratio on common stock for 1984?

- a. 9.6 to 1.
- b. 8.0 to 1.
- c. 6.0 to 1.
- d. 3.5 to 1.

J. Development Stage Enterprises

1N88#55. On July 2, 1988, Creighton Corp. was formed for the purpose of presenting a musical comedy show. The show was scheduled to be presented only on December 30, 1988. A total of 1,000 tickets were sold between July 2 and December 30, including 50 tickets sold between July 2 and July 31. During July, Creighton paid \$12,000 in salaries to actors involved in rehearsals during that month. On July 31, Creighton was considered to be in the development stage of its principal operation. In an income statement prepared for the period July 2 through July 31, 1988, Creighton should report salary expense of

- a. \$0
- b. \$ 600
- c. \$ 2,000
- d. \$12,000

1M88

Items 58 and 59 are based on the following information:

Towne Systems Corp. was a development stage enterprise from October 10, 1985 (inception) to December 31, 1986. The year ended December 31, 1987 is the first year in which Towne is an established operating enterprise. The following are among the costs incurred by Towne:

	For the period 10/10/85 to 12/31/86	For the year ended 12/31/87
Leasehold improvements, equipment, and furniture	\$1,000,000	\$150,000
Security deposits	60,000	15,000
Research and development	750,000	450,000
Laboratory operations	175,000	275,000
General and administrative	250,000	400,000

58. For the period ended December 31, 1986, what total amount of the costs incurred should Towne have capitalized?

- a. \$1,060,000
- b. \$1,810,000
- c. \$1,985,000
- d. \$2,235,000

Selected Questions

59. For the year ended December 31, 1987, what total amount of the costs incurred should Towne have capitalized?

- a. \$875,000
- b. \$615,000
- c. \$165,000
- d. \$150,000

K. Personal Financial Statements

2M89#17. Ron Alda owns 100% of Hako Corp.'s outstanding capital stock. Alda paid \$60,000 for this stock in 1980. At December 31, 1988, the book value of Hako's net assets amounted to \$300,000. It has been ascertained that Alda's 100% stock ownership in Hako had a current value of \$500,000 at December 31, 1988. Alda has an employment contract with Hako under which Alda is to receive a salary of \$100,000 annually for a ten-year period beginning in January 1988. In Alda's personal statement of financial condition at December 31, 1988, what amount should be shown as his net investment in Hako?

- a. \$ 60,000
- b. \$100,000
- c. \$300,000
- d. \$500,000

1N88#59. On December 31, 1987, Shane is a fully-vested participant in a company-sponsored pension plan. According to the plan's administrator, Shane has at that date the nonforfeitable right to receive a lump sum of \$100,000 on December 28, 1988. The discounted amount of \$100,000 is \$90,000 at December 31, 1987. The right is not contingent on Shane's life expectancy and requires no future performance on Shane's part. In Shane's December 31, 1987 personal statement of financial condition, the vested interest in the pension plan should be reported at

- a. \$0
- b. \$ 90,000
- c. \$ 95,000
- d. \$100,000

1M88#60. On December 31, 1987, Mr. and Mrs. Blake owned a parcel of land held as an investment. The land was purchased for \$95,000 in 1980, and was encumbered by a mortgage with a principal balance of \$60,000 at December 31, 1987. On this date the fair value of the land was \$150,000. In the Blakes' December 31, 1987 personal statement of financial condition, at what amount should the land investment and mortgage payable be reported?

	<u>Land investment</u>	<u>Mortgage payable</u>
a.	\$150,000	\$60,000
b.	\$ 95,000	\$60,000
c.	\$ 90,000	\$0
d.	\$ 35,000	\$0

1M87#53. Leslie Shaw's personal statement of financial condition at December 31, 1986, shows net worth of \$400,000 before consideration of employee stock options owned on that date. Information relating to the stock options is as follows:

- Options to purchase 10,000 shares of Korn Corporation stock.
- Option exercise price is \$10 a share.
- Options expire on June 30, 1987.
- Market price of the stock is \$25 a share on December 31, 1986.
- Assume that exercise of the options in 1987 would result in ordinary income taxable at 35%.

After giving effect to the stock options, Shaw's net worth at December 31, 1986, would be

- a. \$497,500
- b. \$550,000
- c. \$562,500
- d. \$650,000

1N86#58. Included in W. Cody's assets at December 31, 1985, are the following:

- 2,000 shares of Dart Corporation common stock purchased in 1982 for \$100,000. The market value of the stock was \$80 per share at December 31, 1985.
- A \$500,000 whole life insurance policy having a cash value of \$72,000 at December 31, 1985, subject to a \$30,000 loan payable to the insurance company.

In Cody's December 31, 1985, personal statement of financial condition, the above assets should be reported at

- a. \$232,000
- b. \$202,000
- c. \$172,000
- d. \$142,000

2M86#3. Jay Dunn owns 50% of the common stock of Nolan Corp. Jay paid \$10,000 for this stock in 1980. At December 31, 1985, it was ascertained that Jay's 50% stock ownership in Nolan had a current value of \$90,000. Nolan's cumulative net income and cash dividends declared for the five years ended December 31, 1985, were \$150,000 and \$20,000 respectively. In Jay's personal statement of financial condition at December 31, 1985, how much should be shown as his net investment in Nolan?

- a. \$90,000
- b. \$85,000
- c. \$75,000
- d. \$10,000

Accounting Practice

1N85

Items 57 and 58 are based on the following data:

Mr. & Mrs. Taft are applying for a bank loan and the bank has requested a personal statement of financial condition as of December 31, 1984. Included in their assets and liabilities at this date are the following:

Assets

Mr. Taft owns 50% of the common stock of Dee Corporation. A shareholders' agreement restricts the sale of the stock and, under certain circumstances, requires Dee to repurchase the stock based on the book value of the net assets, plus an agreed amount for goodwill. At December 31, 1984, the buyout value of Taft's stock is \$675,000. Mr. Taft's tax basis for his Dee stock is \$430,000.

Mrs. Taft owns jewelry appraised on December 31, 1984, at \$70,000 by an independent appraiser for insurance purposes. The jewelry, acquired by purchase and gift over a ten-year period, has a total tax basis of \$40,000.

Liabilities

The Taft residence is encumbered by a mortgage which is payable in monthly installments of \$1,000 through December 1990. Interest at 10% a year is included in the \$1,000 monthly payment. The balance of the mortgage principal is \$58,000 at December 31, 1984.

Mr. Taft has guaranteed the payment of loans of Dee Corporation under a \$300,000 line of credit. The loan balance is \$200,000 at December 31, 1984. Dee's financial condition at December 31, 1984, is such that its repayment of the loan balance is reasonably assured.

57. In the Tafts' December 31, 1984, personal statement of financial condition, the Dee Corporation investment and the jewelry should be reported at a total amount of

- a. \$470,000
- b. \$500,000
- c. \$715,000
- d. \$745,000

58. In the Tafts' December 31, 1984, personal statement of financial condition, the liabilities listed above should be reported at a total amount of

- a. \$ 58,000
- b. \$ 72,000
- c. \$258,000
- d. \$272,000

1M85#60. Mr. & Mrs. Dean require a personal statement of financial condition as of December 31, 1984. Included in their assets at this date are the following:

- A \$300,000 whole life insurance policy (on Mr. Dean) having a cash value of \$43,000 at December 31, 1984, subject to a \$37,000 loan payable to the insurance company.
- A residence purchased in 1980 at a cost of \$150,000. Similar homes in the area are currently selling at approximately \$175,000.

In the Deans' December 31, 1984, personal statement of financial condition, the above assets should be reported at a total amount of

- a. \$218,000
- b. \$193,000
- c. \$181,000
- d. \$156,000

L. Combined Financial Statements

1N88#58. At December 31, 1987, Spud Corp. owned 80% of Jenkins Corp.'s common stock and 90% of Thompson Corp.'s common stock. Jenkins' 1987 net income was \$100,000 and Thompson's 1987 net income was \$200,000. Thompson and Jenkins had no intercompany ownership or transactions during 1987. Combined 1987 financial statements are being prepared for Thompson and Jenkins in contemplation of their sale to an outside party. In the combined income statement, combined net income should be reported at

- a. \$210,000
- b. \$260,000
- c. \$280,000
- d. \$300,000

1M88#53. Mr. and Mrs. Gasson own 100% of the common stock of Able Corp. and 90% of the common stock of Baker Corp. Able previously paid \$4,000 for the remaining 10% interest in Baker. The condensed December 31, 1987 balance sheets of Able and Baker are as follows:

	<u>Able</u>	<u>Baker</u>
Assets	<u>\$600,000</u>	<u>\$60,000</u>
Liabilities	\$200,000	\$30,000
Common stock	100,000	20,000
Retained earnings	<u>300,000</u>	<u>10,000</u>
	<u>\$600,000</u>	<u>\$60,000</u>

In a combined balance sheet of the two corporations at December 31, 1987, what amount should be reported as total stockholders' equity?

- a. \$430,000
- b. \$426,000
- c. \$403,000
- d. \$400,000

Selected Questions

1M87#60. Selected information for two unconsolidated subsidiaries of Ray Company taken from their pre-closing trial balances at December 31, 1986, is as follows:

	<i>Ash Company</i>	<i>Bix Company</i>
	<u>Dr. (Cr.)</u>	<u>Dr. (Cr.)</u>
Inventory, 1/1/86	\$120,000	\$ —
Purchases	190,000	85,000
Shipments to Bix	(80,000)	—
Shipments from Ash	—	100,000
Unrealized inter-company inventory profit	(20,000)	—

Additional data relating to the inventory at December 31, 1986, are as follows:

Inventory acquired from outside parties	\$125,000	\$ 25,000
Bix inventory acquired from Ash	—	30,000

At December 31, 1986, the inventory reported on the combined balance sheet of the two unconsolidated subsidiaries should be

- a. \$150,000
- b. \$160,000
- c. \$174,000
- d. \$180,000

2M86#13. Combined financial statements are being prepared for a group of unconsolidated subsidiaries having intercompany loans of \$100,000 and intercompany profits of \$300,000. How much of these intercompany loans and profits should be eliminated?

	<i>Intercompany</i>	
	<u>Loans</u>	<u>Profits</u>
a.	\$0	\$0
b.	\$0	\$300,000
c.	\$100,000	\$0
d.	\$100,000	\$300,000

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements

2M87

Items 23 through 25 are based on the following data pertaining to Lam Co.'s manufacturing operations:

<u>Inventories</u>	<u>4/1/87</u>	<u>4/30/87</u>
Direct materials	\$18,000	\$15,000
Work-in-process	9,000	6,000
Finished goods	27,000	36,000

Additional information for the month of April 1987:

Direct materials purchased	\$42,000
Direct labor payroll	30,000

Direct labor rate per hour	\$ 7.50
Factory overhead rate per direct labor hour	10.00

23. For the month of April 1987, prime cost incurred was

- a. \$75,000
- b. \$69,000
- c. \$45,000
- d. \$39,000

24. For the month of April 1987, conversion cost incurred was

- a. \$30,000
- b. \$40,000
- c. \$70,000
- d. \$72,000

25. For the month of April 1987, cost of goods manufactured was

- a. \$118,000
- b. \$115,000
- c. \$112,000
- d. \$109,000

2N86#29. Nil Co. uses a predetermined factory overhead application rate based on direct labor cost. For the year ended December 31, 1985, Nil's budgeted factory overhead was \$600,000, based on a budgeted volume of 50,000 direct labor hours, at a standard direct labor rate of \$6.00 per hour. Actual factory overhead amounted to \$620,000, with actual direct labor cost of \$325,000. For 1985, overapplied factory overhead was

- a. \$20,000
- b. \$25,000
- c. \$30,000
- d. \$50,000

Accounting Practice

2N85#1. Boa Corp. distributes service department overhead costs directly to producing departments without allocation to the other service department. Information for the month of June 1985 is as follows:

	<u>Service Departments</u>	
	<u>Maintenance</u>	<u>Utilities</u>
Overhead costs incurred	<u>\$20,000</u>	<u>\$10,000</u>
Service provided to departments:		
Maintenance		10%
Utilities	20%	
Producing — A	40%	30%
Producing — B	40%	60%
Totals	<u>100%</u>	<u>100%</u>

The amount of maintenance department costs distributed to Producing — A department for June 1985 was

- a. \$ 8,000
- b. \$ 8,800
- c. \$10,000
- d. \$11,000

2N85

Items 2 and 3 are based on the following data:

Blum Corp. manufactures plastic coated metal clips. The following were among Blum's 1984 manufacturing costs:

<u>Wages</u>	
Machine operators	\$200,000
Maintenance workers	30,000
Factory foremen	90,000

<u>Materials used</u>	
Metal wire	\$500,000
Lubricant for oiling machinery	10,000
Plastic coating	380,000

2. Blum's 1984 direct labor amounted to
 - a. \$200,000
 - b. \$230,000
 - c. \$290,000
 - d. \$320,000
3. Blum's 1984 direct materials amounted to
 - a. \$890,000
 - b. \$880,000
 - c. \$510,000
 - d. \$500,000

B. Process and Job Order Costing

2M87#40. Bart Co. adds materials at the beginning of the process in Department M. The following information pertains to Department M's work-in-process during April:

	<u>Units</u>
Work-in-process, April 1 (60% complete as to conversion cost)	3,000
Started in April	25,000
Completed	20,000
Work-in-process, April 30 (75% complete as to conversion cost)	8,000

Under the weighted average method, the equivalent units for conversion cost are

- a. 26,000
- b. 25,000
- c. 24,200
- d. 21,800

2N86#27. The following information pertains to Top Co.'s Division D for the month of May:

	<u>Number of units</u>	<u>Cost of materials</u>
Beginning work-in-process	30,000	\$11,000
Started in May	80,000	36,000
Units completed	85,000	
Ending work-in-process	25,000	

All materials are added at the beginning of the process. Using the weighted-average method, the cost per equivalent unit for materials is

- a. \$0.43
- b. \$0.45
- c. \$0.55
- d. \$0.59

2N86#38. Marc Corp. has a job order cost system. The following debits (credits) appeared in the work-in-process account for the month of May 1986:

<u>May</u>	<u>Description</u>	<u>Amount</u>
1	Balance	\$ 10,000
31	Direct materials	60,000
31	Direct labor	40,000
31	Factory overhead	32,000
31	To finished goods	(120,000)

Marc applies overhead to production at a predetermined rate of 80% based on direct labor cost. Job No. 23, the only job still in process at the end of May 1986, has been charged with direct labor of \$5,000. The amount of direct materials charged to Job No. 23 was

- a. \$ 6,250
- b. \$ 7,500
- c. \$13,000
- d. \$17,000

Selected Questions

2M86#22. Lucas Co. has a job order cost system. For the month of April 1986, the following debits (credits) appeared in the general ledger account, work-in-process:

<u>April</u>		
1	Balance	\$24,000
30	Direct materials	80,000
30	Direct labor	60,000
30	Factory overhead	54,000
30	To finished goods	(200,000)

Lucas applies overhead to production at a predetermined rate of 90% based on direct labor cost. Job No. 100, the only job still in process at the end of April, has been charged with factory overhead of \$4,500. The amount of direct materials charged to Job No. 100 was

- a. \$18,000
- b. \$ 8,500
- c. \$ 5,000
- d. \$ 4,500

2M86#25. Kew Co. had 3,000 units in work-in-process at April 1, 1986, which were 60% complete as to conversion cost. During April, 10,000 units were completed. At April 30, 4,000 units remained in work-in-process which were 40% complete as to conversion cost. Direct materials are added at the beginning of the process. How many units were started during April?

- a. 9,000
- b. 9,800
- c. 10,000
- d. 11,000

2M86#28. For the month of April, Thorp Co.'s records disclosed the following data relating to direct labor:

Actual cost	\$10,000
Rate variance	1,000 favorable
Efficiency variance	1,500 unfavorable
Standard cost	<u>\$ 9,500</u>

For the month of April, actual direct labor hours amounted to 2,000. In April, Thorp's standard direct labor rate per hour was

- a. \$5.50
- b. \$5.00
- c. \$4.75
- d. \$4.50

2M85#12. During March 1985 Bly Co.'s Department Y equivalent unit product costs, computed under the weighted-average method, were as follows:

Materials	\$1
Conversion	3
Transferred-in	5

Materials are introduced at the end of the process in Department Y. There were 4,000 units (40% complete as to conversion cost) in work-in-process at March 31, 1985. The total costs assigned to the March 31, 1985, work-in-process inventory should be

- a. \$36,000
- b. \$28,800
- c. \$27,200
- d. \$24,800

2M85

Items 15 and 16* are based on the following data:

Kaden Corp. has two divisions — Ace and Bow. Ace has a job order cost system and manufactures machinery on special order for unrelated customers. Bow has a process cost system and manufactures Product Zee which is sold to Ace as well as to unrelated companies. Ace's work-in-process account at April 30, 1985, comprised the following:

Balance, April 1	\$ 24,000
Direct materials (including transferred-in cost)	80,000
Direct labor	60,000
Factory overhead	54,000
Transferred to finished goods	(200,000)

Ace applies factory overhead at 90% of direct labor cost. Job No. 125, which was the only job in process at April 30, has been charged with factory overhead of \$4,500. Bow's cost to manufacture Product Zee is \$3.00 per unit, which is sold to Ace for \$5.00 per unit and to unrelated customers for \$6.00 per unit.

15. Direct materials (including transferred-in cost) charged to Job No. 125 amounted to

- a. \$ 5,000
- b. \$ 8,500
- c. \$13,500
- d. \$18,000

C. Standard Costing

2M87

Items 32 and 33* are based on the following data:

The following processing standards have been set for Duo Co.'s clerical workers:

Number of hours per 1,000 papers processed	150
Normal number of papers processed per year	1,500,000
Wage rate per 1,000 papers	\$600
Standard variable cost of processing 1,500,000 papers	\$900,000
Fixed costs per year	\$150,000

*The items omitted can be found in other Content Specification Groups.

Accounting Practice

The following information pertains to the 1,200,000 papers that were processed during 1986:

Total cost	\$915,000
Labor cost	\$760,000
Labor hours	190,000

32. For 1986, Duo's expected total cost to process the 1,200,000 papers, assuming standard performance, should be

- \$910,000
- \$900,000
- \$870,000
- \$840,000

2M86

Items 23 and 24 are based on the following data:

Based on a monthly normal volume of 50,000 units (100,000 direct labor hours), Raff Co.'s standard cost system contains the following overhead costs:

Variable	\$6 per unit
Fixed	8 per unit

The following information pertains to the month of March 1986:

Units actually produced	38,000
Actual direct labor hours worked	80,000

Actual overhead incurred:

Variable	\$250,000
Fixed	384,000

23. For March 1986 the unfavorable variable overhead spending variance was

- \$ 6,000
- \$10,000
- \$12,000
- \$22,000

24. For March 1986 the fixed overhead volume variance was

- \$96,000 unfavorable.
- \$96,000 favorable.
- \$80,000 unfavorable.
- \$80,000 favorable.

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap

2M87#31. Axe Co. produces joint products J and K from a process that yields byproduct B. The cost assigned to byproduct B is its market value less additional costs incurred after splitoff. Information concerning a

batch produced in April at a joint cost of \$60,000 is as follows:

Product	Units produced	After Splitoff	
		Additional costs	Market values
J	1,000	\$15,000	\$50,000
K	2,000	10,000	40,000
B	4,000	2,000	5,000

How much of the joint cost should be allocated to the joint products?

- \$53,000
- \$55,000
- \$57,000
- \$58,000

2N86#30. Lee Co. produces two joint products, BEX and ROM. Joint production costs for June 1986 were \$30,000. During June 1986 further processing costs beyond the split-off point, needed to convert the products into salable form, were \$25,000 and \$35,000 for 1,600 units of BEX and 800 units of ROM, respectively. BEX sells for \$50 per unit, and ROM sells for \$100 per unit. Lee uses the net realizable value method for allocating joint product costs. For June 1986, the joint costs allocated to product BEX were

- \$20,000
- \$16,500
- \$13,500
- \$10,000

2N86#37. Dex Co. had the following production for the month of June:

	Units
Work-in-process at June 1	10,000
Started during June	40,000
Completed and transferred to finished goods	33,000
Abnormal spoilage incurred	2,000
Work-in-process at June 30	15,000

Materials are added at the beginning of the process. As to conversion cost, the beginning work-in-process was 70% completed and the ending work-in-process was 60% completed. Spoilage is detected at the end of the process. Using the weighted-average method, the equivalent units for June, with respect to conversion cost, were

- 42,000
- 44,000
- 45,000
- 46,000

Selected Questions

2N86#39. Lite Co. manufactures products X and Y from a joint process that also yields a by-product, Z. Revenue from sales of Z is treated as a reduction of joint costs. Additional information is as follows:

	Products			Total
	X	Y	Z	
Units produced	20,000	20,000	10,000	50,000
Joint costs	?	?	?	\$262,000
Sales value at split-off	\$300,000	\$150,000	\$10,000	\$460,000

Joint costs were allocated using the sales value at split-off approach. The joint costs allocated to product X were

- \$ 75,000
- \$100,800
- \$150,000
- \$168,000

2M86#21. In manufacturing its products for the month of March 1986, Kane Co. incurred normal spoilage of \$10,000 and abnormal spoilage of \$12,000. How much spoilage cost should Kane charge as a period cost for the month of March 1986?

- \$22,000
- \$12,000
- \$10,000
- \$0

2M86#36. Abel Corp. manufactures a product that yields the by-product, "Yum." The only costs associated with Yum are selling costs of \$.10 for each unit sold. Abel accounts for sales of Yum by deducting Yum's separable costs from Yum's sales, and then deducting this net amount from the major product's cost of goods sold. Yum's sales were 100,000 units at \$1 each. If Abel changes its method of accounting for Yum's sales by showing the net amount as additional sales revenue, then Abel's gross margin would

- Increase by \$ 90,000.
- Increase by \$100,000.
- Increase by \$110,000.
- Be unaffected.

2M86#39. Lowe Co. manufactures products A and B from a joint process. Sales value at split-off was \$700,000 for 10,000 units of A, and \$300,000 for 15,000 units of B. Using the sales value at split-off approach,

joint costs properly allocated to A were \$140,000. Total joint costs were

- \$ 98,000
- \$200,000
- \$233,333
- \$350,000

2N85#4. Tish Co. produces two joint products, Ebo and Gel. Joint production costs for May 1985 were \$30,000. During May 1985 further processing costs beyond the split-off point, needed to convert the products into salable form, were \$16,000 and \$24,000 for 1,600 units of Ebo and 800 units of Gel, respectively. Ebo sells for \$25 per unit and Gel sells for \$50 per unit. Tish uses the net realizable value method for allocating joint product costs. What were the joint costs allocated to Ebo for May 1985?

- \$10,000
- \$12,000
- \$18,000
- \$20,000

2N85#5. In its July 1985 production, Gage Corp., which does **not** use a standard cost system, incurred total production costs of \$800,000, of which Gage attributed \$30,000 to normal spoilage and \$20,000 to abnormal spoilage. Gage should account for this spoilage as

- Inventoriable cost of \$30,000 and period cost of \$20,000.
- Period cost of \$30,000 and inventoriable cost of \$20,000.
- Inventoriable cost of \$50,000.
- Period cost of \$50,000.

2N85#6. Lane Co. produces main products Kul and Wu. The process also yields by-product Zef. Net realizable value of by-product Zef is subtracted from joint production cost of Kul and Wu. The following information pertains to production in July 1985 at a joint cost of \$54,000:

Product	Units produced	Market value	Additional cost after split-off
Kul	1,000	\$40,000	\$ 0
Wu	1,500	35,000	0
Zef	500	7,000	3,000

If Lane uses the net realizable value method for allocating joint cost, how much of the joint cost should be allocated to product Kul?

- \$18,800
- \$20,000
- \$26,667
- \$27,342

Accounting Practice

E. Absorption and Variable Costing

2M87#29. During May, Roy Co. produced 10,000 units of Product X. Costs incurred by Roy during May were as follows:

Direct materials	\$10,000
Direct labor	20,000
Variable manufacturing overhead	5,000
Variable selling and general	3,000
Fixed manufacturing overhead	9,000
Fixed selling and general	4,000
Total	<u>\$51,000</u>

Under absorption costing, Product X's unit cost was

- a. \$5.10
- b. \$4.40
- c. \$3.80
- d. \$3.50

2M86#26. Luna Co.'s 1985 manufacturing costs were as follows:

Direct materials and direct labor	\$500,000
Depreciation of manufacturing equipment	70,000
Depreciation of factory building	40,000
Janitor's wages for cleaning factory premises	15,000

How much of these costs should be inventoried for external reporting purposes?

- a. \$625,000
- b. \$610,000
- c. \$585,000
- d. \$500,000

F. Budgeting and Flexible Budgeting

2M87#39. Glo Co., a manufacturer of combs, budgeted sales of 125,000 units for the month of April 1987. The following additional information is provided:

	<i>Number of units</i>
Actual inventory at April 1	
Work-in-process	None
Finished goods	37,500
Budgeted inventory at April 30	
Work-in-process (75% processed)	8,000
Finished goods	30,000

How many equivalent units of production did Glo budget for April 1987?

- a. 126,500
- b. 125,500
- c. 123,500
- d. 117,500

2N86

Items 22 through 26* are based on the following data:

Oslo Co.'s industrial photo-finishing division, Rho, incurred the following costs and expenses in 1985:

	<i>Variable</i>	<i>Fixed</i>
Direct materials	\$200,000	
Direct labor	150,000	
Factory overhead	70,000	\$42,000
General, selling, and administrative	30,000	48,000
Totals	<u>\$450,000</u>	<u>\$90,000</u>

During 1985, Rho produced 300,000 units of industrial photo-prints, which were sold for \$2.00 each. Oslo's investment in Rho was \$500,000 and \$700,000 at January 1, 1985, and December 31, 1985, respectively. Oslo normally imputes interest on investments at 15% of average invested capital.

26. Based on Rho's 1985 financial data, and an estimated 1986 production of 350,000 units of industrial photoprints, Rho's estimated 1986 total costs and expenses would be

- a. \$525,000
- b. \$540,000
- c. \$615,000
- d. \$630,000

G. Breakeven and Cost-Volume-Profit Analysis

2M87

Items 34 through 38* are based on the following selected data pertaining to Mar Co.'s Alo Division for 1986:

Sales	\$100,000
Variable costs	60,000
Traceable fixed costs	10,000
Average invested capital	20,000
Imputed interest rate on average invested capital	12%

In addition, consideration is being given to the possible purchase of a \$30,000 machine for Alo, which is expected to result in a decrease of \$12,000 per year in cash operating expenses. This machine, which has no residual value, has an estimated useful life of five years and will be depreciated on a straight-line basis.

34. Before the purchase of the \$30,000 machine, Alo's breakeven point in sales dollars was

- a. \$16,667
- b. \$25,000
- c. \$30,000
- d. \$70,000

*The items omitted can be found in other Content Specification Groups.

Selected Questions

2N86

Items 22 through 26* are based on the following data:

Oslo Co.'s industrial photo-finishing division, Rho, incurred the following costs and expenses in 1985:

	<u>Variable</u>	<u>Fixed</u>
Direct materials	\$200,000	
Direct labor	150,000	
Factory overhead	70,000	\$42,000
General, selling, and administrative	30,000	48,000
Totals	<u>\$450,000</u>	<u>\$90,000</u>

During 1985, Rho produced 300,000 units of industrial photo-prints, which were sold for \$2.00 each. Oslo's investment in Rho was \$500,000 and \$700,000 at January 1, 1985, and December 31, 1985, respectively. Oslo normally imputes interest on investments at 15% of average invested capital.

24. How many industrial photo-print units did Rho have to sell in 1985 to break even?

- a. 180,000
- b. 120,000
- c. 90,000
- d. 60,000

2N86#34. Kent Co.'s 1985 operating percentages were as follows:

Sales		100%
Cost of sales		
Variable	50%	
Fixed	<u>10</u>	<u>60</u>
Gross profit		40
Other operating expenses		
Variable	20	
Fixed	<u>15</u>	<u>35</u>
Operating income		<u>5%</u>

Kent's 1985 sales totaled \$2,000,000. At what 1985 sales level would Kent break even?

- a. \$1,900,000
- b. \$1,666,667
- c. \$1,250,000
- d. \$ 833,333

2M86#27. The following information pertains to Nova Co.'s cost-volume-profit relationships:

Breakeven point in units sold	1,000
Variable costs per unit	\$ 500
Total fixed costs	\$150,000

*The items omitted can be found in other Content Specification Groups.

How much will be contributed to profit before income taxes by the 1,001st unit sold?

- a. \$650
- b. \$500
- c. \$150
- d. \$0

2M86

Items 29 and 30 are based on the following data pertaining to two types of products manufactured by Korn Corp.:

	<u>Per Unit</u>	
	<u>Sales price</u>	<u>Variable costs</u>
Product Y	\$120	\$ 70
Product Z	500	200

Fixed costs total \$300,000 annually. The expected mix in units is 60% for product Y and 40% for product Z.

29. How much is Korn's breakeven sales in units?

- a. 857
- b. 1,111
- c. 2,000
- d. 2,459

30. How much is Korn's breakeven sales in dollars?

- a. \$300,000
- b. \$420,000
- c. \$475,000
- d. \$544,000

H. Capital Budgeting Techniques

2M87

Items 34 through 38* are based on the following selected data pertaining to Mar Co.'s Alo Division for 1986:

Sales	\$100,000
Variable costs	60,000
Traceable fixed costs	10,000
Average invested capital	20,000
Imputed interest rate on average invested capital	12%

In addition, consideration is being given to the possible purchase of a \$30,000 machine for Alo, which is expected to result in a decrease of \$12,000 per year in cash operating expenses. This machine, which has no residual value, has an estimated useful life of five years and will be depreciated on a straight-line basis.

37. For the new machine, the accounting rate of return based on initial investment would be

- a. 12%
- b. 20%
- c. 30%
- d. 40%

Accounting Practice

38. If income taxes are ignored, the payback period for the new machine would be

- a. 1.67 years.
- b. 2.50 years.
- c. 4.17 years.
- d. 5.00 years.

2N86

Items 31 through 33 are based on the following data:

Allo Foundation, a tax-exempt organization, invested \$200,000 in a five-year project at the beginning of 1985. Allo estimates that the annual cash savings from this project will amount to \$65,000. The \$200,000 of assets will be depreciated over their five-year life on the straight-line basis. On investments of this type, Allo's desired rate of return is 12%. Information on present value factors is as follows:

	<u>At 12%</u>	<u>At 14%</u>	<u>At 16%</u>
Present value of 1 for 5 periods	0.57	0.52	0.48
Present value of an annuity of 1 for 5 periods	3.6	3.4	3.3

31. The net present value of the project is

- a. \$ 34,000
- b. \$ 36,400
- c. \$ 90,000
- d. \$125,000

32. Allo's internal rate of return on this project is

- a. Less than 12%.
- b. Less than 14%, but more than 12%.
- c. Less than 16%, but more than 14%.
- d. More than 16%.

33. For the project's first year, Allo's accounting rate of return, based on the project's average book value for 1985, would be

- a. 14.4%
- b. 13.9%
- c. 12.5%
- d. 12.0%

2N85

Items 7 and 8 are based on the following data:

Apex Corp. is planning to buy production machinery costing \$100,000. This machinery's expected useful life is five years, with no residual value. Apex requires a rate of return of 20%, and has calculated the following data pertaining to the purchase and operation of this machinery:

<u>Year</u>	<u>Estimated annual cash inflow</u>	<u>Present value of 1, at 20%</u>
1	\$ 60,000	.91
2	30,000	.76
3	20,000	.63
4	20,000	.53
5	20,000	.44
Totals	<u>\$150,000</u>	<u>3.27</u>

Assuming that the cash inflow was received evenly during the year,

7. The payback period is

- a. 2.50 years.
- b. 2.75 years.
- c. 3.00 years.
- d. 5.00 years.

8. The net present value is

- a. \$ 9,400
- b. \$ 54,128
- c. \$ 80,000
- d. \$109,400

2M85#13. Oran Co. has the opportunity to invest in a two-year project which is expected to produce cash flows from operations, net of income taxes, of \$100,000 in the first year and \$200,000 in the second year. Oran requires an internal rate of return of 20%. The present value of \$1 for one period at 20% is 0.833 and for two periods at 20% is 0.694. For this project, Oran should be willing to invest immediately a maximum of

- a. \$283,300
- b. \$249,900
- c. \$222,100
- d. \$208,200

I. Performance Analysis

2M87

Items 34 through 38* are based on the following selected data pertaining to Mar Co.'s Alo Division for 1986:

Sales	\$100,000
Variable costs	60,000
Traceable fixed costs	10,000
Average invested capital	20,000
Imputed interest rate on average invested capital	12%

*The items omitted can be found in other Content Specification Groups.

Selected Questions

In addition, consideration is being given to the possible purchase of a \$30,000 machine for Alo, which is expected to result in a decrease of \$12,000 per year in cash operating expenses. This machine, which has no residual value, has an estimated useful life of five years and will be depreciated on a straight-line basis.

35. Before the purchase of the \$30,000 machine, Alo's return on investment was

- a. 60%
- b. 75%
- c. 138%
- d. 150%

36. Before the purchase of the \$30,000 machine, Alo's residual income was

- a. \$27,600
- b. \$30,000
- c. \$32,400
- d. \$40,000

2N86

Items 22 through 26* are based on the following data:

Oslo Co.'s industrial photo-finishing division, Rho, incurred the following costs and expenses in 1985:

	<u>Variable</u>	<u>Fixed</u>
Direct materials	\$200,000	
Direct labor	150,000	
Factory overhead	70,000	\$42,000
General, selling, and administrative	30,000	48,000
Totals	<u>\$450,000</u>	<u>\$90,000</u>

During 1985, Rho produced 300,000 units of industrial photo-prints, which were sold for \$2.00 each. Oslo's investment in Rho was \$500,000 and \$700,000 at January 1, 1985, and December 31, 1985, respectively. Oslo normally imputes interest on investments at 15% of average invested capital.

22. For the year ended December 31, 1985, Rho's return on average investment was

- a. 15.0%
- b. 10.0%
- c. 8.6%
- d. (5.0%)

23. For the year ended December 31, 1985, Rho's residual income (loss) was

- a. \$150,000
- b. \$ 60,000
- c. (\$ 45,000)
- d. (\$ 30,000)

*The items omitted can be found in other Content Specification Groups.

25. For the year ended December 31, 1985, Rho's contribution margin was

- a. \$250,000
- b. \$180,000
- c. \$150,000
- d. \$ 60,000

2M86

Items 37 and 38 are based on the following data:

The following selected data pertain to the Maple Division of Beyer Corp. for 1985:

Sales	\$300,000
Average invested capital	100,000
Operating income	20,000
Capital turnover	3.0
Imputed interest rate	12%

37. The return on investment was

- a. 6.67%
- b. 8.00%
- c. 20.00%
- d. 33.33%

38. The residual income was

- a. \$2,400
- b. \$5,600
- c. \$6,667
- d. \$8,000

2M85

Items 18 and 19 are based on the following data:

The following selected data pertain to Beck Co.'s Beam Division for 1984:

Sales	\$1,000,000
Variable costs	600,000
Traceable fixed costs	100,000
Average invested capital	200,000
Imputed interest rate	15%

18. How much is the residual income?

- a. \$100,000
- b. \$270,000
- c. \$300,000
- d. \$330,000

19. How much is the return on investment?

- a. 75%
- b. 135%
- c. 150%
- d. 200%

Accounting Practice

J. Other

2M87#22. Ral Co. sells 20,000 radios evenly throughout the year. The cost of carrying one unit in inventory for one year is \$8, and the purchase order cost per order is \$32. What is the economic order quantity?

- a. 625
- b. 400
- c. 283
- d. 200

2M87#26. The following standard costs pertain to a component part manufactured by Bor Co.:

Direct materials	\$ 4
Direct labor	10
Factory overhead	40
Standard cost per unit	<u>\$54</u>

Factory overhead is applied at \$1 per standard machine hour. Fixed capacity cost is 60% of applied factory overhead, and is not affected by any "make or buy" decision. It would cost \$49 per unit to buy the part from an outside supplier. In the decision to "make or buy," what is the total relevant unit manufacturing cost?

- a. \$54
- b. \$38
- c. \$30
- d. \$ 5

2M87#27. Meg Co. has developed a regression equation to analyze the behavior of its maintenance costs (Q) as a function of machine hours (Z). The following equation was developed by using 30 monthly observations with a related coefficient of determination of .90:

$$Q = \$6,000 + \$5.25Z$$

If 1,000 machine hours are worked in one month, the related point estimate of total maintenance costs would be

- a. \$11,250
- b. \$10,125
- c. \$ 5,250
- d. \$ 4,725

2M87#28. Aba Caterers quotes a price of \$30 per person for a dinner party. This price includes the 6% sales tax and the 15% service charge. Sales tax is computed on the food plus the service charge. The service charge is computed on the food only. At what amount does Aba price the food?

- a. \$23.70
- b. \$24.61
- c. \$25.50
- d. \$28.20

2M87#30. The following data appeared in the accounting records of a retail store for the year ended December 31, 1986:

Sales	\$150,000
Purchases	70,000
Inventories:	
January 1	35,000
December 31	50,000
Sales commissions	5,000

How much was the gross margin?

- a. \$65,000
- b. \$75,000
- c. \$90,000
- d. \$95,000

2M87

Items 32 and 33* are based on the following data:

The following processing standards have been set for Duo Co.'s clerical workers:

Number of hours per 1,000 papers processed	150
Normal number of papers processed per year	1,500,000
Wage rate per 1,000 papers	\$600
Standard variable cost of processing 1,500,000 papers	\$900,000
Fixed costs per year	\$150,000

The following information pertains to the 1,200,000 papers that were processed during 1986:

Total cost	\$915,000
Labor cost	\$760,000
Labor hours	190,000

33. For 1986, Duo's labor rate variance would be
- a. \$40,000 unfavorable.
 - b. \$32,000 favorable.
 - c. \$10,000 unfavorable.
 - d. \$0.

2M86#21. Tub Co. uses a standard cost system. The following information pertains to direct labor for product B for the month of October:

Actual rate paid	\$8.40 per hour
Standard rate	\$8.00 per hour
Standard hours allowed for actual production	2,000 hours
Labor efficiency variance	\$1,600 unfavorable

What were the actual hours worked?

- a. 1,800
- b. 1,810
- c. 2,190
- d. 2,200

*The items omitted can be found in other Content Specification Groups.

Selected Questions

2N86#28. Lin Co. sells its merchandise at a gross profit of 30%. The following figures are among those pertaining to Lin's operations for the six months ended June 30, 1986:

Sales	\$200,000
Beginning inventory	50,000
Purchases	130,000

On June 30, 1986, all of Lin's inventory was destroyed by fire. The estimated cost of this destroyed inventory was

- a. \$120,000
- b. \$ 70,000
- c. \$ 40,000
- d. \$ 20,000

2N86#35. Clay Co. operates three shipping terminals, referred to as X, Y, and Z. Of the total cargo shipped, terminals X, Y, and Z handle approximately 60%, 30%, and 10%, respectively, with error rates of 3%, 4%, and 6%, respectively. Clay's internal auditor randomly selects one shipping document, ascertaining that this document contains an error. The probability that the error occurred in terminal X is

- a. 60%
- b. 50%
- c. 23%
- d. 3%

2N86#36. During 1985, Seco Corp. experienced the following power outages:

<i>Number of outages per month</i>	<i>Number of months</i>
0	3
1	2
2	4
3	3
	<u>12</u>

Each power outage results in out-of-pocket costs of \$200. For \$250 per month, Seco can lease an auxiliary generator to provide power during outages. If Seco leases an auxiliary generator in 1986, the estimated savings (or additional expenditures) for 1986 would be

- a. \$ 800
- b. \$ 950
- c. (\$ 600)
- d. (\$1,800)

2N86#40. Doe Co. wants to sell a product at a gross margin of 20%. The cost of the product is \$2.00. The selling price should be

- a. \$1.60
- b. \$2.10
- c. \$2.40
- d. \$2.50

2M86#31. Adly Corp. wishes to earn a 30% return on its \$100,000 investment in equipment used to produce product X. Based on estimated sales of 10,000 units of product X next year, the costs per unit would be as follows:

Variable manufacturing costs	\$5
Fixed selling and administrative costs	2
Fixed manufacturing costs	1

At how much per unit should product X be priced for sale?

- a. \$ 5
- b. \$ 8
- c. \$10
- d. \$11

2M86#32. Nada Co.'s pricing structure has been established to yield a gross margin of 30%. The following data pertain to the year ended December 31, 1985:

Sales	\$1,000,000
Inventory, January 1, 1985	500,000
Purchases	400,000
Inventory, per actual count at December 31, 1985	80,000

Nada is satisfied that all sales and purchases have been fully and properly recorded. How much might Nada reasonably estimate as a shortage in inventory at December 31, 1985?

- a. \$100,000
- b. \$120,000
- c. \$200,000
- d. \$276,000

2M86#40. Gata Co. plans to discontinue a department with a \$48,000 contribution to overhead, and allocated overhead of \$96,000, of which \$42,000 cannot be eliminated. What would be the effect of this discontinuance on Gata's pretax profit?

- a. Increase of \$48,000.
- b. Decrease of \$48,000.
- c. Increase of \$6,000.
- d. Decrease of \$6,000.

2N85#9. Information on Rex Co.'s direct material costs for May 1985 is as follows:

Actual quantity of direct materials purchased and used	30,000 lbs.
Actual cost of direct materials	\$84,000
Unfavorable direct materials usage variance	\$ 3,000
Standard quantity of direct materials allowed for May production	29,000 lbs.

For the month of May, what was Rex's direct materials price variance?

- a. \$2,800 favorable.
- b. \$2,800 unfavorable.
- c. \$6,000 unfavorable.
- d. \$6,000 favorable.

Accounting Practice

2M85#20. Bye Co. is considering the sale of banners at the state university football championship game. Bye could purchase these banners for \$0.60 each. Unsold banners would be nonreturnable and worthless after the game. Bye would have to rent a booth at the stadium for \$250. Bye estimates sales of 500 banners at \$2.00 each. If Bye's prediction proves to be incorrect and only 300 banners were sold, the cost of this prediction error would be

- a. \$120
- b. \$130
- c. \$170
- d. \$280

2M85#11. The following information pertains to material X which is used by Sage Co.:

Annual usage in units	20,000
Working days per year	250
Safety stock in units	800
Normal lead time in working days	30

Units of material X will be required evenly throughout the year. The order point is

- a. 800
- b. 1,600
- c. 2,400
- d. 3,200

2M85#14. At December 31, 1984, Zar Co. had a machine with an original cost of \$84,000, accumulated depreciation of \$60,000, and an estimated salvage value of zero. On December 31, 1984, Zar was considering the purchase of a new machine having a five-year life, costing \$120,000, and having an estimated salvage value of \$20,000 at the end of five years. In its decision concerning the possible purchase of the new machine, how much should Zar consider as sunk cost at December 31, 1984?

- a. \$120,000
- b. \$100,000
- c. \$ 24,000
- d. \$ 4,000

2M85#17. Olex Co. is considering a proposal to introduce a new product called Vee. An outside marketing consultant prepared the following probability distribution indicating the relative likelihood of monthly sales volume levels and related income (loss) for Vee:

<u>Monthly sales volume</u>	<u>Probability</u>	<u>Income (loss)</u>
6,000	.10	\$(70,000)
12,000	.20	10,000
18,000	.40	60,000
24,000	.20	100,000
30,000	.10	140,000

If Olex decides to market Vee, the expected value of the added monthly income will be

- a. \$240,000
- b. \$ 60,000
- c. \$ 53,000
- d. \$ 48,000

2M85#20. Box Co. has developed the following regression equation to analyze the behavior of its maintenance costs (Y) as a function of machine hours (X):

$$Y = \$12,000 + \$10.50 X.$$

Thirty monthly observations were used to develop the foregoing equation. The related coefficient of determination was .90. If 1,000 machine hours are worked in one month, the related point estimate of total variable maintenance costs would be

- a. \$ 9,450
- b. \$10,500
- c. \$11,500
- d. \$22,500

VIII. Not-for-Profit and Governmental Accounting

A. Fund Accounting

2M89

Items 21 through 26 are based on the following:

Cliff Township's fiscal year ends on July 31. Cliff uses encumbrance accounting. On October 2, 1988, an approved \$5,000 purchase order was issued for supplies. Cliff received these supplies on November 2, 1988, and the \$5,000 invoice was approved for payment by the general fund.

During the year ended July 31, 1989, Cliff received a state grant of \$150,000 to finance the purchase of a senior citizens recreation bus, and an additional \$15,000 grant to be used for bus operations during the year ended July 31, 1989. Only \$125,000 of the capital grant was used during the year ended July 31, 1989 for the bus purchase, but the entire operating grant of \$15,000 was disbursed during the year.

Cliff's governing body adopted its general fund budget for the year ending July 31, 1990, comprising estimated revenues of \$50,000,000 and appropriations

Selected Questions

of \$40,000,000. Cliff formally integrates its budget into the accounting records.

21. What accounts should Cliff debit and credit on October 2, 1988 to record the approved \$5,000 purchase order?

<u>Debit</u>	<u>Credit</u>
a. Encumbrances control	Appropriations control
b. Appropriations control	Encumbrances control
c. Encumbrances control	Budgetary fund balance — reserved for encumbrances
d. Budgetary fund balance — reserved for encumbrances	Encumbrances control

22. What accounts should Cliff debit and credit on November 2, 1988 upon receipt of the supplies and approval of the \$5,000 invoice?

<u>Debit</u>	<u>Credit</u>
a. Budgetary fund balance — reserved for encumbrances	Encumbrances control
Expenditures control	Vouchers payable
b. Encumbrances control	Budgetary fund balance — reserved for encumbrances
Appropriations control	Vouchers payable
c. Appropriations control	Encumbrances control
Supplies inventory	Vouchers payable
d. Encumbrances control	Appropriations control
Expenditures control	Vouchers payable

23. The senior citizens recreation bus program is accounted for as part of Cliff's general fund. What amount should Cliff report as grant revenues for the year ended July 31, 1989 in connection with the state grants?

- a. \$165,000
- b. \$150,000
- c. \$140,000
- d. \$125,000

24. When Cliff records budgeted revenues, estimated revenues control should be

- a. Debited for \$10,000,000.
- b. Credited for \$10,000,000.
- c. Debited for \$50,000,000.
- d. Credited for \$50,000,000.

25. To record the \$40,000,000 of budgeted appropriations, Cliff should

- a. Debit estimated expenditures control.
- b. Credit estimated expenditures control.
- c. Debit appropriations control.
- d. Credit appropriations control.

26. The \$10,000,000 budgeted excess of revenues over appropriations should be

- a. Debited to budgetary fund balance—unreserved.
- b. Credited to budgetary fund balance—unreserved.
- c. Debited to estimated excess revenues control.
- d. Credited to estimated excess revenues control.

2M88

Items 44 through 50 are based on the following information:

Maple Township uses encumbrance accounting, and formally integrates its budget into the accounting records for its general fund. For the year ending June 30, 1988, the Township Council adopted a budget comprising estimated revenues of \$10,000,000, appropriations of \$9,000,000, and an estimated transfer of \$300,000 to the debt service fund. The following additional information is provided:

- For the month of April 1988, salaries and wages expense of \$200,000 was incurred.
- On April 10, 1988, an approved \$1,500 purchase order was issued for supplies. These supplies were received on May 1, 1988, and the \$1,500 invoice was approved for payment.
- In November 1987, an unexpected state grant of \$100,000 was received to finance the purchase of school buses, and an additional grant of \$5,000 was received for bus maintenance and operations. Only \$60,000 of the capital grant was used in the current year for the purchase of buses, but the entire operating grant of \$5,000 was disbursed in the current year. The remaining \$40,000 of the capital grant is expected to be expended during the year ending June 30, 1989. Maple's school bus system is appropriately accounted for in the capital projects fund.

44. On adoption of the budget, the journal entry to record the budgetary fund balance should include a

- a. Debit of \$700,000.
- b. Credit of \$700,000.
- c. Debit of \$1,000,000.
- d. Credit of \$1,000,000.

Accounting Practice

45. Budgeted revenues would be recorded by a
- Debit to estimated revenues control, \$10,000,000.
 - Debit to estimated revenues receivable, \$10,000,000.
 - Credit to estimated revenues, \$10,000,000.
 - Credit to other financing sources control, \$10,000,000.
46. Budgeted appropriations would be recorded by a
- Debit to estimated expenditures, \$9,300,000.
 - Credit to appropriations control, \$9,300,000.
 - Debit to estimated expenditures, \$9,000,000.
 - Credit to appropriations control, \$9,000,000.

47. What journal entry should be made on April 10, 1988, to record the approved purchase order?

	<u>Debit</u>	<u>Credit</u>
a. Expenditures control	\$1,500	
Encumbrances control		\$1,500
b. Encumbrances control	1,500	
Expenditures control		1,500
c. Encumbrances control	1,500	
Fund balance reserved for encumbrances		1,500
d. Encumbrances control	1,500	
Appropriations control		1,500

48. What journal entries should be made on May 1, 1988, upon receipt of the supplies and approval of the invoice?

	<u>Debit</u>	<u>Credit</u>
a. Encumbrances control	\$1,500	
Appropriations control		\$1,500
Supplies expense	1,500	
Vouchers payable		1,500
b. Fund balance reserved for encumbrances	1,500	
Encumbrances control		1,500
Expenditures control	1,500	
Vouchers payable		1,500
c. Appropriations control	1,500	
Encumbrances control		1,500
Expenditures control	1,500	
Vouchers payable		1,500
d. Expenditures control	1,500	
Encumbrances control		1,500
Supplies expense	1,500	
Vouchers payable		1,500

49. In connection with the grants for the purchase of school buses and bus maintenance and operations, what amount should be reported as grant revenues for the year ending June 30, 1988?

- \$ 5,000
- \$ 60,000
- \$ 65,000
- \$100,000

50. What journal entry should be made to record the salaries and wages expense incurred for April?

	<u>Debit</u>	<u>Credit</u>
a. Salaries and wages expense	\$200,000	
Vouchers payable		\$200,000
b. Appropriations control	200,000	
Vouchers payable		200,000
c. Encumbrances control	200,000	
Vouchers payable		200,000
d. Expenditures control	200,000	
Vouchers payable		200,000

B. Types of Funds and Fund Accounts

2M89#28. On December 31, 1988, Park Township paid a contractor \$4,000,000 for the total cost of a new police building built in 1988. Financing was by means of a \$3,000,000 general obligation bond issue sold at face amount on December 31, 1988, with the remaining \$1,000,000 transferred from the general fund. What amount should Park record as revenues in the capital projects fund in connection with the bond issue proceeds and the transfer?

- \$0
- \$1,000,000
- \$3,000,000
- \$4,000,000

2M89#39. The following fund types used by Green Township had total assets at June 30, 1989 as follows:

Agency funds	\$ 300,000
Debt service funds	1,000,000

Total fiduciary fund assets amount to

- \$0
- \$ 300,000
- \$1,000,000
- \$1,300,000

2N88

Items 41 and 42 are based on the following:

On December 31, 1987, Vane City paid a contractor \$3,000,000 for the total cost of a new municipal annex built in 1987 on city-owned land. Financing was provided by a \$2,000,000 general obligation bond issue sold at face amount on December 31, 1987, with the remaining \$1,000,000 transferred from the general fund.

41. What account and amount should be reported in Vane's 1987 financial statements for the general fund?

- Other financing uses control, \$1,000,000.
- Other financing sources control, \$2,000,000.
- Expenditures control, \$3,000,000.
- Other financing sources control, \$3,000,000.

Selected Questions

42. What accounts and amounts should be reported in Vane's 1987 financial statements for the capital projects fund?

- a. Other financing sources control, \$2,000,000;
General long-term debt, \$2,000,000.
- b. Revenues control, \$2,000,000;
Expenditures control, \$2,000,000.
- c. Other financing sources control, \$3,000,000;
Expenditures control, \$3,000,000.
- d. Revenues control, \$3,000,000;
Expenditures control, \$3,000,000.

2N88#43. The following information for the year ended June 30, 1988 pertains to a proprietary fund established by Burwood Village in connection with Burwood's public parking facilities:

Receipts from users of parking facilities	\$400,000
Expenditures	
Parking meters	210,000
Salaries and other cash expenses	90,000
Depreciation of parking meters	70,000

For the year ended June 30, 1988, this proprietary fund should report net income of

- a. \$0
- b. \$ 30,000
- c. \$100,000
- d. \$240,000

2N88#44. The following proceeds received by Grove City in 1987 are legally restricted to expenditure for specified purposes:

Donation by a benefactor mandated to an expendable trust fund to provide meals for the needy	\$300,000
Sales taxes to finance the maintenance of tourist facilities in the shopping district	900,000

What amount should be accounted for in Grove's special revenue funds?

- a. \$0
- b. \$ 300,000
- c. \$ 900,000
- d. \$1,200,000

2N88#45. In connection with Albury Township's long-term debt, the following cash accumulations are available to cover payment of principal and interest on

Bonds for financing of water treatment plant construction	\$1,000,000
General long-term obligations	400,000

The amount of these cash accumulations that should be accounted for in Albury's debt service funds is

- a. \$0
- b. \$ 400,000
- c. \$1,000,000
- d. \$1,400,000

2N88#46. During its fiscal year ended June 30, 1988, Lake County financed the following projects by special assessments:

Capital improvements	\$2,000,000
Service-type projects	800,000

For financial reporting purposes, what amount should appear in special assessment funds?

- a. \$2,800,000
- b. \$2,000,000
- c. \$ 800,000
- d. \$0

2N88#47. Hull City has established a separate internal service (self-insurance) fund to pay claims and judgments of all of Hull's funds. In 1987, payments to the insurer fund amounted to \$500,000, while the actuarially determined amount was \$400,000. The payments to the insurer fund should be accounted for as

	<u>An operating transfer of</u>	<u>A residual equity transfer of</u>
a.	\$0	\$0
b.	\$100,000	\$400,000
c.	\$400,000	\$100,000
d.	\$500,000	\$0

2N88#48. The following fund types used by Cliff City had total assets at December 31, 1987 as follows:

Special revenue funds	\$100,000
Agency funds	150,000
Trust funds	200,000

Total fiduciary fund assets amounted to

- a. \$200,000
- b. \$300,000
- c. \$350,000
- d. \$450,000

2N88#49. The following information pertains to a computer that Pine Township leased from Karl Supply Co. on July 1, 1988, for general township use:

Karl's cost	\$5,000
Fair value at July 1, 1988	\$5,000
Estimated economic life	5 years
Fixed noncancelable term	30 months
Rental at beginning of each month	\$135
Guaranteed residual value	\$2,000
Present value of minimum lease payments at July 1, 1988, using Pine's incremental borrowing rate of 10.5%	\$5,120
Karl's implicit interest rate of 12.04%	\$5,000

Accounting Practice

On July 1, 1988, what amount should Pine capitalize in its general fixed assets account group for this leased computer?

- a. \$0
- b. \$3,000
- c. \$5,000
- d. \$5,120

2N88#51. Lane Foundation received a nonexpendable endowment of \$500,000 in 1986 from Gant Enterprises. The endowment assets were invested in publicly traded securities. Gant did not specify how gains and losses from dispositions of endowment assets were to be treated. No restrictions were placed on the use of dividends received and interest earned on fund resources. In 1987, Lane realized gains of \$50,000 on sales of fund investments, and received total interest and dividends of \$40,000 on fund securities. The amount of these capital gains, interest, and dividends available for expenditure by Lane's unrestricted current fund is

- a. \$0
- b. \$40,000
- c. \$50,000
- d. \$90,000

2N88#52. In 1987, the Board of Trustees of Burr Foundation designated \$100,000 from its current funds for college scholarships. Also in 1987, the foundation received a bequest of \$200,000 from an estate of a benefactor who specified that the bequest was to be used for hiring teachers to tutor handicapped students. What amount should be accounted for as current restricted funds?

- a. \$0
- b. \$100,000
- c. \$200,000
- d. \$300,000

2M88#41. The following items were among Wood Township's expenditures from the general fund during the year ended June 30, 1987:

Furniture for Township Hall	\$10,000
Minicomputer for tax collector's office	15,000

The amount that should be classified as fixed assets in Wood's general fund balance sheet at June 30, 1987 is

- a. \$25,000
- b. \$15,000
- c. \$10,000
- d. \$0

2M88#42. During 1987, Pine City recorded the following receipts from self-sustaining activities paid for by users of the services rendered:

Municipal bus system	\$1,000,000
Operation of water supply and sewerage plant	1,800,000

What amount should be accounted for in Pine's enterprise funds?

- a. \$2,800,000
- b. \$1,800,000
- c. \$1,000,000
- d. \$0

2M88#43. Grove County collects property taxes levied within its boundaries and receives a 1% fee for administering these collections on behalf of the municipalities located in the county. In 1987, Grove collected \$1,000,000 for its municipalities and remitted \$990,000 to them after deducting fees of \$10,000. In the initial recording of the 1% fee, Grove's agency fund should credit

- a. Fund balance — agency fund, \$10,000.
- b. Fees earned — agency fund, \$10,000.
- c. Due to Grove County general fund, \$10,000.
- d. Revenues control, \$10,000.

2N87#47. The following information pertains to Wood Township's long-term debt:

Cash accumulations to cover payment of principal and interest on

General long-term obligations	\$350,000
Proprietary fund obligations	100,000

How much of these cash accumulations should be accounted for in Wood's debt service funds?

- a. \$0
- b. \$100,000
- c. \$350,000
- d. \$450,000

2N87#48. In 1986, Menton City received \$5,000,000 of bond proceeds to be used for capital projects. Of this amount, \$1,000,000 was expended in 1986. Expenditures for the \$4,000,000 balance were expected to be incurred in 1987. These bond proceeds should be recorded in capital projects funds for

- a. \$5,000,000 in 1986.
- b. \$5,000,000 in 1987.
- c. \$1,000,000 in 1986 and \$4,000,000 in 1987.
- d. \$1,000,000 in 1986 and in the general fund for \$4,000,000 in 1986.

2N87#52. The following proceeds were received by Kew City from specific revenue sources that are legally restricted to expenditure for specified purposes:

Gasoline taxes to finance road repairs	\$400,000
Levies on affected property owners to finance sidewalk repairs	300,000

The amount that should be accounted for in Kew's special revenue funds is

- a. \$0
- b. \$300,000
- c. \$400,000
- d. \$700,000

Selected Questions

2N87#53. Wells Township issued the following long-term obligations:

Revenue bonds to be repaid from admission fees collected by the township swimming pool	\$500,000
General obligation bonds issued for the township water and sewer fund which will service the debt	900,000

Although the above-mentioned bonds are expected to be paid from enterprise funds, the full faith and credit of Wells Township has been pledged as further assurance that the liabilities will be paid. What amount of these bonds should be accounted for in the general long-term debt account group?

- a. \$1,400,000
- b. \$ 900,000
- c. \$ 500,000
- d. \$0

2N87#54. Lake City operates a centralized data processing center through an internal service fund, to provide data processing services to Lake's other governmental units. In 1986, this internal service fund billed Lake's water and sewer fund \$100,000 for data processing services. How should the internal service fund record this billing?

	<u>Debit</u>	<u>Credit</u>
a. Memorandum entry only	—	—
b. Due from water and sewer fund	\$100,000	
Data processing department expenses		\$100,000
c. Intergovernmental transfers	\$100,000	
Interfund exchanges		\$100,000
d. Due from water and sewer fund	\$100,000	
Operating revenues control		\$100,000

2N87#55. Burr City has approved a special assessment project providing for total assessments of \$300,000, to be collected from affected property owners in five equal annual installments starting in 1987. The entry to be made to record the levy of assessments in 1987 is

	<u>Debit</u>	<u>Credit</u>
a. Special assessments receivable — current	\$ 60,000	
Special assessments receivable — deferred	240,000	
Revenues control		\$ 60,000
Deferred revenues		240,000
b. Special assessments receivable — current	\$ 60,000	
Revenues control		\$ 60,000
c. Special assessments receivable	\$300,000	
Revenues control		\$300,000
d. Special assessments receivable	\$300,000	
Deferred revenues		\$300,000

2N87#56. Dodd Village received a gift of a new fire engine from a local resident. The fair market value of this fire engine was \$200,000. The entry to be made in the general fixed assets account group for this gift is

	<u>Debit</u>	<u>Credit</u>
a. Machinery and equipment	\$200,000	
Investment in general fixed assets from private gifts		\$200,000
b. Investment in general fixed assets	\$200,000	
Gift revenue		\$200,000
c. General fund assets	\$200,000	
Private gifts		\$200,000
d. Memorandum entry only	—	—

2N87

Items 57 and 58* are based on the following information pertaining to the sale of equipment by Nous Foundation, a voluntary health and welfare organization:

Sales price	\$12,000
Cost	14,000
Carrying amount	10,000

Nous made the correct entry to record the \$2,000 gain on sale.

58. The amount that should be debited and credited for the additional entry in connection with this sale is

- a. \$ 2,000
- b. \$10,000
- c. \$12,000
- d. \$14,000

D. Various Types of Not-for-Profit and Governmental Organizations

2M89

Items 29 through 31 are based on the following information pertaining to Lori Hospital for the year ended May 31, 1989:

In March 1989, a \$300,000 unrestricted bequest and a \$500,000 pure endowment grant were received. In April 1989, a bank notified Lori that the bank received \$10,000 to be held in permanent trust by the bank. Lori is to receive the income from this donation.

29. Lori should record the \$300,000 unrestricted bequest as

- a. Nonoperating revenue.
- b. Other operating revenue.
- c. A direct credit to the fund balance.
- d. A credit to operating expenses.

*The items omitted can be found in other Content Specification Groups.

Accounting Practice

30. The \$500,000 pure endowment grant
- May be expended by the governing board only to the extent of the principal since the income from this fund must be accumulated.
 - Should be reported as nonoperating revenue when the full amount of principal is expended.
 - Should be recorded as a memorandum entry only.
 - Should be accounted for as restricted funds upon receipt.
31. The \$10,000 donation being held by the bank in permanent trust should be
- Recorded in Lori's restricted endowment fund.
 - Recorded by Lori as nonoperating revenue.
 - Recorded by Lori as other operating revenue.
 - Disclosed in notes to Lori's financial statements.

2M89

Items 32 through 34* are based on the following information pertaining to Cabal University as of June 30, 1989 and for the year then ended:

Unrestricted current funds comprised \$7,500,000 of assets and \$4,500,000 of liabilities (including deferred revenues of \$150,000). Among the receipts recorded during the year were unrestricted gifts of \$550,000 and restricted grants totaling \$330,000, of which \$220,000 was expended during the year for current operations and \$110,000 remained unexpended at the close of the year.

Volunteers from the surrounding communities regularly contribute their services to Cabal and are paid nominal amounts to cover their travel costs. During the year, the total amount paid to these volunteers aggregated \$18,000. The gross value of services performed by them, determined by reference to equivalent wages available in that area for similar services, amounted to \$200,000.

32. At June 30, 1989, the fund balance of Cabal's unrestricted current funds was
- \$7,500,000
 - \$3,150,000
 - \$3,000,000
 - \$2,850,000
33. For the year ended June 30, 1989, what amount should be included in Cabal's current funds revenues for the unrestricted gifts and restricted grants?
- \$550,000
 - \$660,000
 - \$770,000
 - \$880,000

*The items omitted can be found in other Content Specification Groups.

2M89

Items 36 through 38 are based on the following information pertaining to Rega Foundation, a voluntary welfare organization funded by contributions from the general public:

During 1988, unrestricted pledges of \$600,000 were received, of which it was estimated that \$72,000 would be uncollectible. By the end of 1988, \$480,000 of the pledges had been collected, and it was expected that an additional \$48,000 of these pledges would be collected in 1989, with the balance to be written off as uncollectible. Donors did **not** specify any periods during which the donations were to be used.

Also during 1988, Rega sold a computer for \$18,000. Its cost was \$21,000 and its book value was \$15,000. Rega made the correct entry to record the gain on sale.

36. What amount should Rega include under public support in 1988 for net contributions?
- \$480,000
 - \$528,000
 - \$531,000
 - \$600,000
37. In addition to the entry recording the gain on sale of the computer, the other accounts that Rega should debit and credit in connection with this sale are
- | | Debit | Credit |
|-------------------------------|-------|---------------------------|
| a. Current unrestricted funds | | Fund balance—undesignated |
| b. Excess revenues control | | Sale of equipment |
| c. Fund balance—unexpended | | Fund balance—expended |
| d. Fund balance—expended | | Fund balance—unexpended |
38. The amount that should be debited and credited for the additional entry in connection with the sale of the computer is
- \$ 3,000
 - \$15,000
 - \$18,000
 - \$21,000

2N88#53. The following information pertains to interest received by Beech University from endowment fund investments for the year ended June 30, 1988:

	<u>Received</u>	<u>Expended for current operations</u>
Unrestricted	\$300,000	\$100,000
Restricted	500,000	75,000

What amount should be credited to endowment income for the year ended June 30, 1988?

- \$800,000
- \$375,000
- \$175,000
- \$100,000

Selected Questions

2N88#54. On July 31, 1988, Sabio College showed the following amounts to be used for

Renewal and replacement of college properties	\$200,000
Retirement of indebtedness on college properties	300,000
Purchase of physical properties for college purposes, but unexpended at 7/31/88	400,000

What total amount should be included in Sabio's plant funds at July 31, 1988?

- a. \$900,000
- b. \$600,000
- c. \$400,000
- d. \$200,000

2N88#56. Under Cura Hospital's established rate structure, patient service revenues of \$9,000,000 would have been earned for the year ended December 31, 1987. However, only \$6,750,000 was collected because of charity allowances of \$1,500,000 and discounts of \$750,000 to third-party payors. For the year ended December 31, 1987, what amount should Cura record as patient service revenues?

- a. \$6,750,000
- b. \$7,500,000
- c. \$8,250,000
- d. \$9,000,000

2N88#57. An organization of high school seniors performs services for patients at Leer Hospital. These students are volunteers and perform services that the hospital would not otherwise provide, such as wheeling patients in the park and reading to patients. Leer has no employer-employee relationship with these volunteers, who donated 5,000 hours of service to Leer in 1987. At the minimum wage rate, these services would amount to \$18,750, while it is estimated that the fair value of these services was \$25,000. In Leer's 1987 statement of revenues and expenses, what amount should be reported as nonoperating revenue?

- a. \$25,000
- b. \$18,750
- c. \$ 6,250
- d. \$0

2N88#58. In June 1988, Park Hospital purchased medicines from Jove Pharmaceutical Co. at a cost of \$2,000. However, Jove notified Park that the invoice was being canceled, and that the medicines were being donated to Park. Park should record this donation of medicines as

- a. A memorandum entry only.
- b. Other operating revenue of \$2,000.
- c. A \$2,000 credit to operating expenses.
- d. A \$2,000 credit to nonoperating expenses.

2N88#59. In 1987, a nonprofit trade association enrolled five new member companies, each of which was obligated to pay nonrefundable initiation fees of \$1,000.

These fees were receivable by the association in 1987. Three of the new members paid the initiation fees in 1987, and the other two new members paid their initiation fees in 1988. Annual dues (excluding initiation fees) received by the association from all of its members have always covered the organization's costs of services provided to its members. It can be reasonably expected that future dues will cover all costs of the organization's future services to members. Average membership duration is 10 years because of mergers, attrition, and economic factors. What amount of initiation fees from these five new members should the association recognize as revenue in 1987?

- a. \$5,000
- b. \$3,000
- c. \$ 500
- d. \$0

2N88#60. On January 2, 1987, a nonprofit botanical society received a gift of an exhaustible fixed asset with an estimated useful life of 10 years and no salvage value. The donor's cost of this asset was \$20,000, and its fair market value at the date of the gift was \$30,000. What amount of depreciation of this asset should the society recognize in its 1987 financial statements?

- a. \$3,000
- b. \$2,500
- c. \$2,000
- d. \$0

2M88#51. On March 1, 1988, Allan Rowe established a \$100,000 endowment fund, the income from which is to be paid to Elm Hospital for general operating purposes. Elm does not control the fund's principal. Rowe appointed West National Bank as trustee of this fund. What journal entry is required by Elm to record the establishment of the endowment?

	<i>Debit</i>	<i>Credit</i>
a. Cash	\$100,000	
Nonexpendable endowment fund		\$100,000
b. Cash	100,000	
Endowment fund balance		100,000
c. Nonexpendable endowment fund	100,000	
Endowment fund balance		100,000
d. Memorandum entry only	—	—

2M88#52. In 1988, Wells Hospital received an unrestricted bequest of common stock with a fair market value of \$50,000 on the date of receipt of the stock. The testator had paid \$20,000 for this stock in 1986. Wells should record this bequest as

- a. Nonoperating revenue of \$50,000.
- b. Nonoperating revenue of \$30,000.
- c. Nonoperating revenue of \$20,000.
- d. A memorandum entry only.

Accounting Practice

2M88#53. Cedar Hospital has a marketable equity securities portfolio that is appropriately included in non-current assets in unrestricted funds. The portfolio has an aggregate cost of \$300,000. It had an aggregate fair market value of \$250,000 at the end of 1987 and \$290,000 at the end of 1986. If the portfolio was properly reported in the balance sheet at the end of 1986, the change in the valuation allowance at the end of 1987 should be

- a. \$0.
- b. A decrease of \$40,000.
- c. An increase of \$40,000.
- d. An increase of \$50,000.

2M88#54. Ross Hospital's accounting records disclosed the following information:

- Net resources invested in plant assets \$10,000,000
- Board-designated funds 2,000,000

What amount should be included as part of unrestricted funds?

- a. \$12,000,000
- b. \$10,000,000
- c. \$ 2,000,000
- d. \$0

2M88#55. In April 1987, Alice Reed donated \$100,000 cash to her church, with the stipulation that the income generated from this gift is to be paid to Alice during her lifetime. The conditions of this donation are that, after Alice dies, the principal can be used by the church for any purpose voted on by the church elders. The church received interest of \$8,000 on the \$100,000 for the year ended March 31, 1988, and the interest was remitted to Alice. In the church's March 31, 1988 financial statements

- a. \$8,000 should be reported under support and revenue in the activity statement.
- b. \$92,000 should be reported under support and revenue in the activity statement.
- c. \$100,000 should be reported as deferred support in the balance sheet.
- d. The gift and its terms should be disclosed only in notes to the financial statements.

2M88#56. The following expenditures were among those incurred by a nonprofit botanical society during 1987:

Printing of annual report	\$10,000
Unsolicited merchandise sent to encourage contributions	20,000

What amount should be classified as fund-raising costs in the society's activity statement?

- a. \$0
- b. \$10,000
- c. \$20,000
- d. \$30,000

2M88#57. Unity Fund is a voluntary welfare organization funded by contributions from the general public. During 1987, unrestricted pledges of \$100,000 were received, half of which were payable in 1987, with the other half payable in 1988 for use in 1988. It was estimated that 20% of these pledges would be uncollectible. With respect to the pledges, the amount that should be reported for 1987 as net contributions, under public support, is

- a. \$100,000
- b. \$ 80,000
- c. \$ 50,000
- d. \$ 40,000

2M88#58. For the 1987 summer session, Selva University assessed its students \$300,000 for tuition and fees. However, the net amount realized was only \$290,000 because of the following reductions:

Tuition remissions granted to faculty members' families	\$3,000
Class cancellation refunds	7,000

How much unrestricted current funds revenues from tuition and fees should Selva report for the period?

- a. \$290,000
- b. \$293,000
- c. \$297,000
- d. \$300,000

2M88#59. The following information was available from Forest College's accounting records for its current funds for the year ended March 31, 1988:

Restricted gifts received	
Expended	\$100,000
Not expended	300,000
Unrestricted gifts received	
Expended	600,000
Not expended	75,000

What amount should be included in current funds revenues for the year ended March 31, 1988?

- a. \$ 600,000
- b. \$ 700,000
- c. \$ 775,000
- d. \$1,000,000

2M88#60. The following expenditures were among those incurred by Alma University during 1987:

Administrative data processing	\$ 50,000
Scholarships and fellowships	100,000
Operation and maintenance of physical plant	200,000

The amount to be included in the functional classification "Institutional Support" expenditures account is

- a. \$ 50,000
- b. \$150,000
- c. \$250,000
- d. \$350,000

Selected Questions

2N87#41. Cura Hospital's property, plant, and equipment, net of depreciation, amounted to \$10,000,000, with related mortgage liabilities of \$1,000,000. What amount should be included in the restricted fund grouping?

- a. \$0
- b. \$ 1,000,000
- c. \$ 9,000,000
- d. \$10,000,000

2N87#42. For the summer session of 1987, Ariba University assessed its students \$1,700,000 (net of refunds), covering tuition and fees for educational and general purposes. However, only \$1,500,000 was expected to be realized because scholarships totaling \$150,000 were granted to students, and tuition remissions of \$50,000 were allowed to faculty members' children attending Ariba. What amount should Ariba include in the unrestricted current funds as revenues from student tuition and fees?

- a. \$1,500,000
- b. \$1,550,000
- c. \$1,650,000
- d. \$1,700,000

2N87#43. Park College is sponsored by a religious group. Volunteers from this religious group regularly contribute their services to Park, and are paid nominal amounts to cover their commuting costs. During 1986, the total amount paid to these volunteers aggregated \$12,000. The gross value of services performed by them, determined by reference to lay-equivalent salaries, amounted to \$300,000. What amount should Park record as expenditures in 1986 for these volunteers' services?

- a. \$312,000
- b. \$300,000
- c. \$ 12,000
- d. \$0

2N87#44. Abbey University's unrestricted current funds comprised the following:

Assets	\$5,000,000
Liabilities (including deferred revenues of \$100,000)	3,000,000

The fund balance of Abbey's unrestricted current funds was

- a. \$1,900,000
- b. \$2,000,000
- c. \$2,100,000
- d. \$5,000,000

2N87#45. The following receipts were among those recorded by Kery College during 1986:

Unrestricted gifts	\$500,000
Restricted current funds (expended for current operating purposes)	200,000
Restricted current funds (not yet expended)	100,000

The amount that should be included in current funds revenues is

- a. \$800,000
- b. \$700,000
- c. \$600,000
- d. \$500,000

2N87#46. Palma Hospital's patient service revenues for services provided in 1986, at established rates, amounted to \$8,000,000 on the accrual basis. For internal reporting, Palma uses the discharge method. Under this method, patient service revenues are recognized only when patients are discharged, with no recognition given to revenues accruing for services to patients not yet discharged. Patient service revenues at established rates using the discharge method amounted to \$7,000,000 for 1986. According to generally accepted accounting principles, Palma should report patient service revenues for 1986 of

- a. Either \$8,000,000 or \$7,000,000, at the option of the hospital.
- b. \$8,000,000
- c. \$7,500,000
- d. \$7,000,000

2N87#49. Aviary Haven, a voluntary welfare organization funded by contributions from the general public, received unrestricted pledges of \$500,000 during 1986. It was estimated that 12% of these pledges would be uncollectible. By the end of 1986, \$400,000 of the pledges had been collected, and it was expected that \$40,000 more would be collected in 1987, with the balance of \$60,000 to be written off as uncollectible. Donors did not specify any periods during which the donations were to be used. What amount should Aviary include under public support in 1986 for net contributions?

- a. \$500,000
- b. \$452,000
- c. \$440,000
- d. \$400,000

2N87#50. During 1986, Shaw Hospital purchased medicines for hospital use totaling \$800,000. Included in this \$800,000 was an invoice of \$10,000 that was canceled in 1986 by the vendor because the vendor wished to donate this medicine to Shaw. This donation of medicine should be recorded as

- a. A \$10,000 reduction of medicine expense.
- b. An increase in other operating revenue of \$10,000.
- c. A direct \$10,000 credit to the general (unrestricted) funds balance.
- d. A \$10,000 credit to the restricted funds balance.

2N87#51. In 1986, Pyle Hospital received a \$250,000 pure endowment fund grant. Also in 1986, Pyle's governing board designated, for special uses, \$300,000

Accounting Practice

which had originated from unrestricted gifts. What amount of these resources should be accounted for as part of general (unrestricted) funds?

- a. \$0
- b. \$250,000
- c. \$300,000
- d. \$550,000

2N87

Items 57 and 58* are based on the following information pertaining to the sale of equipment by Nous Foundation, a voluntary health and welfare organization:

Sales price	\$12,000
Cost	14,000
Carrying amount	10,000

Nous made the correct entry to record the \$2,000 gain on sale.

57. The additional entry that Nous should record in connection with this sale is

<u>Debit</u>	<u>Credit</u>
a. Fund balance — expended	Fund balance — unexpended
b. Fund balance — unexpended	Fund balance — expended

<u>Debit</u>	<u>Credit</u>
c. Excess revenues control	Sale of equipment
d. Current unrestricted funds	Fund balance — undesignated

2N87#59. The following funds are among those maintained by Arlon City:

Enterprise funds	\$2,000,000
Internal service funds	800,000

Arlon's proprietary funds amount to

- a. \$0
- b. \$ 800,000
- c. \$2,000,000
- d. \$2,800,000

2N87#60. Payne Hospital received an unrestricted bequest of \$100,000 in 1986. This bequest should be recorded as

- a. A memorandum entry only.
- b. Other operating revenue of \$100,000.
- c. Nonoperating revenue of \$100,000.
- d. A direct credit of \$100,000 to the fund balance.

IX. Federal Taxation — Individuals, Estates, and Trusts

A. Inclusions for Gross Income and Adjusted Gross Income

2M89

Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:

Sam — age 72; normal vision.
Ann — age 67; legally blind.

Adjusted gross income — \$34,000.

The Hoyts itemized their deductions.

Among the Hoyts' cash receipts during 1988 were the following:

\$1,000 dividends from taxable domestic corporations on stocks held in Sam's name.

\$4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for \$9,000. The Hoyts had no other capital gains or losses in the current or prior years.

*The items omitted can be found in other Content Specification Groups.

\$6,000 first installment on a \$75,000 life insurance policy payable to Ann in annual installments of \$6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts' cash expenditures during 1988 were the following:

\$2,000 transportation expenses required under the terms of Sam's employment contract were paid by Sam, an outside salesman. No reimbursement was received.

\$2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of \$50,000. Fair market value was \$60,000 before the fire and \$55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.

\$800 appraisal fee to determine amount of fire loss.

\$3,000 real estate tax on residence; \$400 state and city sales taxes; \$900 state income tax.

\$100 contribution to a recognized political party.

44. What was the taxable amount of dividends on Hoyts' 1988 return?

- a. \$1,000
- b. \$ 900
- c. \$ 800
- d. \$ 700

Selected Questions

45. What was the allowable amount of long-term capital loss that the Hoyts could offset against ordinary income on their 1988 return?

- a. \$0
- b. \$2,500
- c. \$3,000
- d. \$5,000

2M89#54. With regard to the passive loss rules involving rental real estate activities, which one of the following statements is correct?

- a. The term "passive activity" includes any rental activity without regard as to whether or not the taxpayer materially participates in the activity.
- b. Gross investment income from interest and dividends **not** derived in the ordinary course of a trade or business is treated as passive activity income that can be offset by passive rental activity losses when the "active participation" requirement is **not** met.
- c. Passive rental activity losses may be deducted only against passive income, but passive rental activity credits may be used against tax attributable to nonpassive activities.
- d. The passive activity rules do **not** apply to taxpayers whose adjusted gross income is \$300,000 or less.

2N88#1. Blair, CPA, uses the cash receipts and disbursements method of reporting. In 1987, a client gave Blair 100 shares of a listed corporation's stock in full satisfaction of a \$5,000 accounting fee the client owed Blair. This stock had a fair market value of \$4,000 on the date it was given to Blair. The client's basis for this stock was \$3,000. Blair sold the stock for cash in January 1988. In Blair's 1987 return, what amount of income should be reported in connection with the receipt of the stock?

- a. \$0
- b. \$3,000
- c. \$4,000
- d. \$5,000

2N88#2. Smith, a retired corporate executive, earned consulting fees of \$8,000 and director's fees of \$2,000 in 1987. Smith's gross income from self-employment in 1987 was

- a. \$0
- b. \$ 2,000
- c. \$ 8,000
- d. \$10,000

2N88#3. Pierre, a headwaiter, received tips totaling \$2,000 in December 1987. On January 5, 1988, Pierre reported this tip income to his employer in the required

written statement. At what amount, and in which year, should this tip income be included in Pierre's gross income?

- a. \$2,000 in 1987.
- b. \$2,000 in 1988.
- c. \$1,000 in 1987, and \$1,000 in 1988.
- d. \$ 167 in 1987, and \$1,833 in 1988.

2N88#5. If an individual taxpayer's passive losses and credits relating to rental real estate activities cannot be used in the current year, then they may be carried

- a. Back three years, but they cannot be carried forward.
- b. Forward up to a maximum period of 15 years, but they cannot be carried back.
- c. Back three years or forward up to 15 years, at the taxpayer's election.
- d. Forward indefinitely or until the property is disposed of in a taxable transaction.

2N88#6. In 1987, Ben Loy and his wife, Ann, received dividends of \$500 and \$25, respectively, from taxable domestic corporations. What amount of these dividends could be excluded from the Loy's taxable income on their 1987 joint return?

- a. \$0
- b. \$125
- c. \$200
- d. \$225

2N88#7. With regard to the alimony deduction in connection with a 1988 divorce, which one of the following statements is correct?

- a. Alimony is deductible by the payor spouse, and includible by the payee spouse, to the extent that payment is contingent on the status of the divorced couple's children.
- b. The divorced couple may be members of the same household at the time alimony is paid, provided that the persons do not live as husband and wife.
- c. Alimony payments must terminate on the death of the payee spouse.
- d. Alimony may be paid either in cash or in property.

2N88#8. A 1988 capital loss incurred by a married couple filing a joint return

- a. Will be allowed only to the extent of capital gains.
- b. Will be allowed to the extent of capital gains, plus up to \$3,000 of ordinary income.
- c. May be carried forward up to a maximum of five years.
- d. Is **not** an allowable loss.

Accounting Practice

2N88#9. In 1988, Joan accepted and received a \$10,000 award for outstanding civic achievement. Joan was selected without any action on her part, and no future services are expected of her as a condition of receiving the award. What amount should Joan include in her 1988 adjusted gross income in connection with this award?

- a. \$0
- b. \$ 4,000
- c. \$ 5,000
- d. \$10,000

2M88#1. John Budd is single, with no dependents. During 1987, John received wages of \$11,000 and state unemployment compensation benefits of \$2,000. He had no other source of income. The amount of state unemployment compensation benefits that should be included in John's 1987 adjusted gross income is

- a. \$2,000
- b. \$1,000
- c. \$ 500
- d. \$0

2M88#2. In 1987, Emil Gow won \$5,000 in a state lottery. Also in 1987, Emil spent \$400 for the purchase of lottery tickets. Emil elected the standard deduction on his 1987 income tax return. The amount of lottery winnings that should be included in Emil's 1987 taxable income is

- a. \$0
- b. \$2,000
- c. \$4,600
- d. \$5,000

2M88#3. In 1970, Betty Lane bought 100 shares of a listed corporation's stock for \$8,000. In 1987, Betty sold this stock for \$15,000. Betty had no other capital gains or losses in 1987. How much of the 1987 long-term capital gain should be included in Betty's 1987 taxable income?

- a. \$2,800
- b. \$3,500
- c. \$4,200
- d. \$7,000

2M88#4. For a married couple filing a 1987 joint return, the excess of net long-term capital loss over net short-term capital gain is

- a. Reduced by 50% before being deducted from ordinary income.
- b. Limited to a maximum deduction of \$3,000 from ordinary income.
- c. Allowed as a carryover against future capital gains up to a maximum period of five years.
- d. Not deductible from ordinary income.

2M88#5. Al and Iris Oran, who are married, received \$10,000 in 1987 as dividends from taxable domestic corporations. In the Orans' 1987 joint return, the amount of these dividends subject to tax is

- a. \$10,000
- b. \$ 9,900
- c. \$ 9,800
- d. \$ 8,500

2M88#6. During 1987, Ruth Loy received interest income as follows:

On U.S. Treasury certificates	\$3,000
On refund of 1985 federal income tax	200

The total amount of interest subject to tax in Ruth's 1987 return is

- a. \$0
- b. \$ 200
- c. \$3,000
- d. \$3,200

2M88#9. Gary Judd is an individual proprietor trading as Lake Stores, an accrual basis enterprise that had been using the reserve method for determining bad debt expense for both book and tax purposes. At December 31, 1986, Lake's allowance for doubtful accounts ("bad debt reserve") was \$20,000. In Lake's 1987 budget, it was estimated that \$3,000 of trade accounts receivable would become worthless in 1987. However, actual bad debts amounted to \$4,000 in 1987. In Lake's 1987 Schedule C of Form 1040, Lake is allowed

- a. A \$4,000 deduction for bad debts, but must also include \$5,000 of the "reserve" in taxable income.
- b. A \$4,000 deduction for bad debts, and does **not** have to include any portion of the "reserve" in taxable income.
- c. No deduction for bad debts since these bad debts should be charged against the "reserve."
- d. A \$1,000 deduction for bad debts, which is the excess of actual bad debts over the amount estimated.

2N87#1. John Budd files a joint return with his wife. Budd's employer pays 100% of the cost of all employees' group term life insurance under a qualified plan. Under this plan, the maximum amount of tax-free coverage that may be provided for Budd by his employer is

- a. \$100,000
- b. \$ 50,000
- c. \$ 10,000
- d. \$ 5,000

Selected Questions

2N87#2. In 1987, Al Oran bought a paved vacant lot adjacent to his retail store for use as a customers' parking lot at a cost of \$15,000. In addition, Oran bought new store fixtures costing \$8,000. What portion of these assets constitutes capital assets?

- a. \$0
- b. \$ 8,000
- c. \$15,000
- d. \$23,000

2N87#3. Emil Gow owns a two-family house which has two identical apartments. Gow lives in one apartment and rents out the other. In 1987, the rental apartment was fully occupied and Gow received \$7,200 in rent. During the year ended December 31, 1987, Gow paid the following:

Real estate taxes	\$6,400
Painting of rental apartment	800
Annual fire insurance premium	600

In 1987, depreciation for the entire house was determined to be \$5,000. What amount should Gow include in his adjusted gross income for 1987?

- a. \$2,900
- b. \$ 800
- c. \$ 400
- d. \$ 100

2N87#4. With regard to tax recognition of alimony in connection with a 1987 divorce, which one of the following statements is correct?

- a. The divorced couple may be members of the same household at the time payments are made.
- b. Payments may be made either in cash or in property.
- c. If the payor spouse pays premiums for insurance on his life as a requirement under the divorce agreement, the premiums are alimony if the payor spouse owns the policy.
- d. Payments must terminate at the death of the payee spouse.

2N87#6. Under the cash method of reporting, an individual should report gross income

- a. Only for the year in which income is actually received in cash.
- b. Only for the year in which income is actually received either in cash or in property.
- c. For the year in which income is either actually or constructively received in cash only.
- d. For the year in which income is either actually or constructively received either in cash or in property.

2N87#7. The following information pertains to installment sales of personal use property made by Fred Dale in his retail furniture store:

Year of sale	Installment sales	Gross profit	Collections in 1987
1985	\$ 50,000	\$15,000	\$10,000
1986	100,000	40,000	30,000
1987	150,000	75,000	40,000

These sales were **not** under a revolving credit plan. Under the installment method, Dale should report gross profit for 1987 of

- a. \$ 35,000
- b. \$ 75,000
- c. \$ 80,000
- d. \$130,000

2N87#8. Under a \$150,000 insurance policy on her deceased father's life, Mary Green is to receive \$12,000 per year for 15 years. Of the \$12,000 received in 1987, the amount subject to income tax is

- a. \$0
- b. \$ 1,000
- c. \$ 2,000
- d. \$12,000

2N87#9. In 1987, Gail Judd received the following dividends from

Benefit Life Insurance Co., on Gail's life insurance policy (Total dividends received have not yet exceeded accumulated premiums paid)	\$100
Safe National Bank, on bank's common stock	300
Roe Mfg. Corp., a Delaware corporation, on preferred stock	500

What amount of dividend income should Gail report in her 1987 income tax return?

- a. \$900
- b. \$800
- c. \$500
- d. \$300

2N87#10. Paul Crane, age 25, and single with no dependents, had an adjusted gross income of \$30,000 in 1987, exclusive of \$2,000 in unemployment compensation benefits received in 1987. The amount of Crane's unemployment compensation benefits taxable for 1987 is

- a. \$2,000
- b. \$1,000
- c. \$ 500
- d. \$0

Accounting Practice

2M86#41. For assets acquired in 1986, the holding period for determining long-term capital gains and losses is more than

- 6 months.
- 9 months.
- 12 months.
- 15 months.

2M86#42. Fringe benefits received by an employee are generally subject to employment taxes or withholding

- For statutory fringe benefits only.
- If the fringe benefits are nonstatutory.
- Regardless of the statutory or nonstatutory nature of the fringe benefits.
- At the option of the employer.

2M86#45. Kirk Kory, a cash basis sole proprietor, had the following cash receipts and disbursements for 1985:

Net sales	\$120,000
Dividend income (on personal investment)	800
Cost of sales	60,000
Other operating expenses	12,000
State business tax	1,200
Federal self-employment tax	3,200

What amount should Kory report as net earnings from self-employment for 1985?

- \$43,600
- \$46,800
- \$47,600
- \$48,000

2M86#49. During the current year Hal Leff sustained a serious injury in the course of his employment. As a result of this injury, Hal received the following payments during the year:

Worker's compensation	\$2,400
Reimbursement from his employer's accident and health plan for medical expenses paid by Hal and not deducted by him	1,800
Damages for personal injuries	8,000

The amount to be included in Hal's gross income for the current year should be

- \$12,200
- \$ 8,000
- \$ 1,800
- \$0

2M86#52. Jason Budd, CPA, reports on the cash basis. In April 1984, Budd billed a client \$3,500 for the following professional services:

Personal estate planning	\$2,000
Personal tax return preparation	1,000
Compilation of business financial statements	500

No part of the \$3,500 was ever paid. In April 1986, the client declared bankruptcy, and the \$3,500 obligation became totally uncollectible. What loss can Budd deduct on his 1986 tax return for this bad debt?

- \$0
- \$ 500
- \$1,500
- \$3,500

2N85

Items 24 through 27 are based on the following data:

Amy Finch had the following cash receipts during 1984:

Interest on Veterans Administration insurance dividends left on deposit with the V.A.	\$ 10
Interest on state income tax refund	18
Net rent on vacant lot used by a car dealer (lessee pays all taxes, insurance, and other expenses on the lot)	6,000
Advance rent from lessee of above vacant lot, such advance to be applied against rent for the last two months of the 5-year lease in 1988	1,000
Dividend from a mutual insurance company on a life insurance policy	500
Dividend on listed corporation stock; payment date by corporation was 12/30/83, but Amy received the dividend in the mail on 1/2/84	875
Gross amount of state lottery winnings (Amy spent \$900 on state lottery tickets and \$700 on pari-mutuel bets in 1984 at the state off-track betting parlor, for which she has full documentation)	2,400

Amy did not itemize her deductions on her 1984 return. Total dividends received to date on the life insurance policy do not exceed the aggregated premiums paid by Amy.

24. How much should Amy include in her 1984 taxable income for interest?

- \$0
- \$10
- \$18
- \$28

25. How much should Amy include in her 1984 taxable income for rent?

- \$7,000
- \$6,800
- \$6,200
- \$6,000

Selected Questions

26. How much should Amy report for dividend income for 1984, before any applicable exclusions?

- a. \$1,375
- b. \$ 875
- c. \$ 500
- d. \$0

27. How much should Amy include in taxable "Other Income" for her 1984 state lottery winnings?

- a. \$2,400
- b. \$1,700
- c. \$1,500
- d. \$ 800

2N85#28. Neil and Lynn Barta are married and filed a joint 1984 return. For 1984, how much was the limit on capital losses that the Bartas could apply against other income after offsetting capital gains?

- a. \$0
- b. \$1,000
- c. \$1,500
- d. \$3,000

2N85#31. With regard to alimony in connection with a 1985 divorce, which of the following statements is true?

- a. Alimony may be paid either in cash or in property.
- b. Alimony must terminate at the death of the payee spouse.
- c. The divorced couple may be members of the same household at the time alimony is paid.
- d. Alimony may be deductible by the payor spouse to the extent that payment is contingent on the status of the divorced couple's child.

2N85#33. For assets acquired in 1985, the holding period for determining long-term capital gains and losses is more than

- a. 18 months.
- b. 12 months.
- c. 9 months.
- d. 6 months.

2M85

Items 21 and 22* are based on the following data:

Ana and Gus Hill were granted a divorce in 1984. They had no children. In accordance with the decree, which specified that payments would cease at Ana's death, Gus made the following payments to Ana in 1984:

Lump-sum cash settlement	\$25,000
Indefinite periodic payments	2,100

*The items omitted can be found in other Content Specification Groups.

21. How much should Ana include in her 1984 taxable income as alimony?

- a. \$0
- b. \$ 2,100
- c. \$25,000
- d. \$27,100

2M85

Items 23 and 24 are based on the following data:

Ray Birch, age 60, is single with no dependents. Birch's only income is from his occupation as a self-employed plumber. Birch owns the following assets used in his plumbing business:

	<i>Adjusted basis</i>
Land on which a storage shack is erected	\$ 3,000
Shack for storage of plumbing supplies	12,000

23. Birch must file a return for 1985 if his net earnings from self-employment are at least

- a. \$ 400
- b. \$1,000
- c. \$2,300
- d. \$3,300

24. The capital assets used by Birch in his business amount to

- a. \$0
- b. \$ 3,000
- c. \$12,000
- d. \$15,000

2M85

Items 25 through 29* are based on the following data:

Emil and Judy Ryan are married and file a joint return. They have no children. Emil is 68 and Judy is 60. They contribute over half of the support for Judy's mother, Cora, age 85, who earned \$800 from baby sitting jobs and received \$1,900 in social security benefits during 1984. Cora lives alone in her own apartment.

Emil earned a salary of \$60,000 in 1984 from his job at Korma Corp., where Emil is covered by his employer's pension plan. Judy, who worked part-time in 1984 and earned \$1,000, is not covered by an employer's pension plan. Other items received jointly by Emil and Judy in 1984 were as follows:

Life insurance proceeds on the death of an unrelated friend	\$8,000
Interest on income tax refund	100
Interest on life insurance policy's accumulated dividends	300
Dividends on stock of a Swiss corporation	500
Dividend on life insurance policy	200

Accounting Practice

28. How much interest income should be reported by the Ryans in their 1984 return?

- a. \$0
- b. \$100
- c. \$300
- d. \$400

29. How much of the dividends are reportable by the Ryans in their 1984 return?

- a. \$0
- b. \$200
- c. \$500
- d. \$700

2M85#31. The following information pertains to Nat Krug, a cash basis sole proprietor, for the year ended December 31, 1984:

Gross receipts from business	\$120,000
Dividend income from personal investments	800
Cost of goods sold	60,000
Other business operating expenses	12,000
State business taxes	1,200
Federal self-employment tax	4,271

For the year ended December 31, 1984, how much should Krug report as net earnings from self-employment?

- a. \$42,529
- b. \$46,800
- c. \$47,600
- d. \$48,000

2M85#32. The following information pertains to the acquisition of a six-wheel truck by Sol Barr, a self-employed contractor:

Cost of original truck traded in	\$20,000
Book value of original truck at trade-in date	4,000
List price of new truck	25,000
Trade-in allowance for old truck	6,000
Business use of both trucks	100%

A reduced regular investment tax credit was elected in lieu of reducing the basis of the new truck. The new truck will be depreciated as 3-year ACRS property. The basis of the new truck is

- a. \$27,000
- b. \$25,000
- c. \$23,000
- d. \$19,000

2M85#37. On July 1, 1980, Lila Perl paid \$90,000 for 450 shares of Janis Corp. common stock. Lila received a nontaxable stock dividend of 50 new common shares in December 1981. On December 20, 1984, Lila sold the 50 new shares for \$11,000. How much should Lila

report in her 1984 return as long-term capital gain, before the capital gain deduction?

- a. \$0
- b. \$ 1,000
- c. \$ 2,000
- d. \$11,000

B. Exclusions and Adjustments to Arrive at Adjusted Gross Income

2M89

Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:

Sam — age 72; normal vision.

Ann — age 67; legally blind.

Adjusted gross income — \$34,000.

The Hoyts itemized their deductions.

Among the Hoyts' cash receipts during 1988 were the following:

\$1,000 dividends from taxable domestic corporations on stocks held in Sam's name.

\$4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for \$9,000. The Hoyts had no other capital gains or losses in the current or prior years.

\$6,000 first installment on a \$75,000 life insurance policy payable to Ann in annual installments of \$6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts' cash expenditures during 1988 were the following:

\$2,000 transportation expenses required under the terms of Sam's employment contract were paid by Sam, an outside salesman. No reimbursement was received.

\$2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of \$50,000. Fair market value was \$60,000 before the fire and \$55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.

\$800 appraisal fee to determine amount of fire loss.

\$3,000 real estate tax on residence; \$400 state and city sales taxes; \$900 state income tax.

\$100 contribution to a recognized political party.

46. What portion of the \$6,000 installment on the life insurance policy is excludible from 1988 gross income in arriving at Hoyts' adjusted gross income?

- a. \$0
- b. \$1,000
- c. \$5,000
- d. \$6,000

*The items omitted can be found in other Content Specification Groups.

Selected Questions

2N88#10. Which one of the following types of allowable deductions can be claimed as a deduction in arriving at an individual's 1988 adjusted gross income?

- a. Unreimbursed business expenses of an outside salesman-employee.
- b. Personal casualty losses.
- c. Charitable contributions.
- d. Alimony payments.

2N88#11. Sol and Julia Crane are married, and filed a joint return for 1987. Sol earned a salary of \$80,000 in 1987 from his job at Troy Corp., where Sol is covered by his employer's pension plan. In addition, Sol and Julia earned interest of \$3,000 in 1987 on their joint savings account. Julia is not employed, and the couple had no other income. On January 15, 1988, Sol contributed \$2,000 to an IRA for himself, and \$250 to an IRA for his spouse. The allowable IRA deduction in the Cranes' 1987 joint return is

- a. \$0
- b. \$ 250
- c. \$2,000
- d. \$2,250

2M88#15. Paul and Lois Lee, both age 50, are married and filed a joint return for 1987. Their 1987 adjusted gross income was \$80,000, including Paul's \$75,000 salary. Lois had no income of her own. Neither spouse was covered by an employer-sponsored pension plan. What amount could the Lees contribute to IRAs for 1987 to take advantage of their maximum allowable IRA deduction in their 1987 return?

- a. \$0
- b. \$2,000
- c. \$2,250
- d. \$4,000

2M88#16. Eric Kay, age 59, is single and has no dependents. In 1988, Eric sold his personal residence for the net amount of \$300,000 after all selling expenses. He bought the house in 1960 and occupied it until sold. The house had a basis of \$100,000 on the date of sale. Eric moved into a rental apartment and does not intend to buy another residence. What is the maximum portion of the gain on sale of the residence that Eric may exclude from his 1988 taxable income?

- a. \$0
- b. \$ 62,500
- c. \$125,000
- d. \$200,000

2N87#5. For the year ended December 31, 1986, Don Raff earned \$1,000 interest at Ridge Savings Bank on a certificate of deposit scheduled to mature in 1988. In January 1987, before filing his 1986 income tax return, Raff incurred a forfeiture penalty of \$500 for premature withdrawal of the funds. Raff should treat this \$500 forfeiture penalty as a

- a. Reduction of interest earned in 1986, so that only \$500 of such interest is taxable on Raff's 1986 return.
- b. Deduction from 1987 adjusted gross income, deductible only if Raff itemizes his deductions for 1987.
- c. Penalty **not** deductible for tax purposes.
- d. Deduction from gross income in arriving at 1987 adjusted gross income.

2M86#51. Joel Rich is an outside salesman, deriving his income solely from commissions, and personally bearing all expenses without reimbursement of any kind. During 1985, Joel paid the following expenses pertaining directly to his activities as an outside salesman:

Travel	\$10,000
Secretarial	7,000
Telephone	1,000

How should these expenses be deducted in Joel's 1985 return?

	<i>From gross income, in arriving at adjusted gross income</i>	<i>As itemized deductions</i>
a.	\$18,000	\$0
b.	\$11,000	\$ 7,000
c.	\$10,000	\$ 8,000
d.	\$0	\$18,000

2N85

Items 21 and 22 are based on the following data:

Gary Barth, who is unmarried, owns a house which has been his principal residence for the past ten years. Gary wants to sell this house and move to a rental apartment. He has no intention of buying another residence at any time in the future, but wishes to avail himself of the one-time exclusion of gain on the sale of his house.

21. What is the minimum age Gary must attain in order to avail himself of the one-time exclusion of gain on sale of his house?

- a. 55
- b. 65
- c. 70
- d. 72

22. Assume that Gary has attained the required age to qualify for the one-time exclusion of gain on the sale of his house. What is the maximum amount allowable for this type of exclusion?

- a. 40% of long-term gain.
- b. 60% of long-term gain.
- c. \$100,000.
- d. \$125,000.

Accounting Practice

2M85

Items 21 and 22* are based on the following data:

Ana and Gus Hill were granted a divorce in 1984. They had no children. In accordance with the decree, which specified that payments would cease at Ana's death, Gus made the following payments to Ana in 1984:

Lump-sum cash settlement	\$25,000
Indefinite periodic payments	2,100

22. Gus does not itemize his deductions. How much can Gus deduct as alimony in his 1984 return?

- a. \$0
- b. \$ 2,100
- c. \$25,000
- d. \$27,100

2M85

Items 25 through 29* are based on the following data:

Emil and Judy Ryan are married and file a joint return. They have no children. Emil is 68 and Judy is 60. They contribute over half of the support for Judy's mother, Cora, age 85, who earned \$800 from baby sitting jobs and received \$1,900 in social security benefits during 1984. Cora lives alone in her own apartment.

Emil earned a salary of \$60,000 in 1984 from his job at Korma Corp., where Emil is covered by his employer's pension plan. Judy, who worked part-time in 1984 and earned \$1,000, is not covered by an employer's pension plan. Other items received jointly by Emil and Judy in 1984 were as follows:

Life insurance proceeds on the death of an unrelated friend	\$8,000
Interest on income tax refund	100
Interest on life insurance policy's accumulated dividends	300
Dividends on stock of a Swiss corporation	500
Dividend on life insurance policy	200

26. The Ryans do not itemize their deductions. How much can they contribute to IRAs in order to take advantage of their maximum allowable deduction for IRAs in their 1984 return?

- a. \$0
- b. \$1,000
- c. \$2,250
- d. \$3,000

C. Gain or Loss on Property Transactions

2M89#41. In 1989, Ruth Lee sold a painting for \$25,000 that she had bought for her personal use in

1979 at a cost of \$10,000. In her 1989 return, Lee should treat the sale of the painting as a transaction resulting in

- a. Ordinary income.
- b. Long-term capital gain.
- c. Section 1231 gain.
- d. No taxable gain.

2M89#42. The following information pertains to the sale of Al Oran's principal residence:

Date of sale	May 1989
Date of purchase	May 1979
Net sales price	\$260,000
Adjusted basis	\$ 70,000

In June 1989, Oran (age 70) bought a smaller residence for \$90,000. Oran elected to avail himself of the exclusion of realized gain available to taxpayers age 55 and over. What amount of gain should Oran recognize in 1989 on the sale of his residence?

- a. \$45,000
- b. \$65,000
- c. \$70,000
- d. \$90,000

2M89#52. On June 1, 1988, Ben Rork sold 500 shares of Kul Corp. stock. Rork had received this stock on May 1, 1988 as a bequest from the estate of his uncle, who died on March 1, 1988. Rork's basis was determined by reference to the stock's fair market value on March 1, 1988. Rork's holding period for this stock was

- a. Short-term.
- b. Long-term.
- c. Short-term if sold at a gain; long-term if sold at a loss.
- d. Long-term if sold at a gain; short-term if sold at a loss.

2N87

Items 18 through 20 are based on the following data:

In 1980, Iris King bought a diamond necklace for her own use, at a cost of \$10,000. In 1987, when the fair market value was \$12,000, Iris gave this necklace to her daughter, Ruth. No gift tax was due.

18. Ruth's holding period for this gift
 - a. Starts in 1987.
 - b. Starts in 1980.
 - c. Depends on whether the necklace is sold by Ruth at a gain or at a loss.
 - d. Is irrelevant because Ruth received the necklace for no consideration of money or money's worth.
19. This diamond necklace is a
 - a. Capital asset.
 - b. Section 1231 asset.
 - c. Section 1245 asset.
 - d. Section 1250 asset.

*The items omitted can be found in other Content Specification Groups.

Selected Questions

20. If Ruth sells this diamond necklace in 1988 for \$13,000, Ruth's recognized gain would be
- \$3,000
 - \$2,000
 - \$1,000
 - \$0

2M86#44. At December 31, 1985, the following assets were among those owned by Eli York:

<u>Date acquired</u>	<u>A</u>	<u>Cost</u>
Jan. 1984	Personal residence	\$100,000
Feb. 1984	Stock of listed corp.	8,000
Dec. 1985	Stock of listed corp.	3,000

How much were the capital assets?

- \$111,000
- \$108,000
- \$ 11,000
- \$ 8,000

2M86

Items 54 and 55 are based on the following data:

In January 1985, Joan Hill bought one share of Orban Corp. stock for \$300. On March 1, 1985, Orban distributed one share of preferred stock for each share of common stock held. This distribution was nontaxable. On March 1, 1985, Joan's one share of common stock had a fair market value of \$450, while the preferred stock had a fair market value of \$150.

54. After the distribution of the preferred stock, Joan's bases for her Orban stocks are

	<u>Common</u>	<u>Preferred</u>
a.	\$300	\$0
b.	\$225	\$ 75
c.	\$200	\$100
d.	\$150	\$150

55. The holding period for the preferred stock starts in

- January 1985.
- March 1985.
- September 1985.
- December 1985.

2M86#58. Pat Leif owned an apartment house that he bought in 1970. Depreciation was taken on a straight-line basis. In 1985, when Pat's adjusted basis for this property was \$200,000, he traded it for an office building having a fair market value of \$600,000. The apartment house has 100 dwelling units, while the office building has 40 units rented to business enterprises. The properties are **not** located in the same city. What is Pat's reportable gain on this exchange?

- \$400,000 Section 1250 gain.
- \$400,000 Section 1231 gain.
- \$400,000 long-term capital gain.
- \$0.

2M85

Items 38 through 40* are based on the following data:

On July 1, 1984, Kim Wald sold an antique for \$15,000 that she had bought for her personal use in 1981 at a cost of \$12,000. Also on July 1, 1984, Kim sold 100 shares of Ral Corp. stock. Kim had received this stock on March 1, 1984, as a bequest from the estate of John Wolf who died on January 2, 1984, when this stock had a fair market value of \$8,000. The executor of John's estate did not elect the alternate valuation. John had bought this stock in 1970 for \$1,000.

38. In her 1984 return, Kim should treat the sale of the antique as a transaction resulting in

- No taxable gain.
- Ordinary income.
- Short-term capital gain.
- Long-term capital gain.

40. Kim's holding period for the 100 shares of Ral stock was

- Long-term.
- Short-term.
- Long-term if sold at a gain; short-term if sold at a loss.
- Short-term if sold at a gain; long-term if sold at a loss.

D. Deductions From Adjusted Gross Income

2M89

Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:

Sam — age 72; normal vision.
Ann — age 67; legally blind.

Adjusted gross income — \$34,000.

The Hoyts itemized their deductions.

Among the Hoyts' cash receipts during 1988 were the following:

- \$1,000 dividends from taxable domestic corporations on stocks held in Sam's name.
- \$4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for \$9,000. The Hoyts had **no** other capital gains or losses in the current or prior years.
- \$6,000 first installment on a \$75,000 life insurance policy payable to Ann in annual installments of \$6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

*The items omitted can be found in other Content Specification Groups.

Accounting Practice

Among the Hoyts' cash expenditures during 1988 were the following:

\$2,000 transportation expenses required under the terms of Sam's employment contract were paid by Sam, an outside salesman. No reimbursement was received.

\$2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of \$50,000. Fair market value was \$60,000 before the fire and \$55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.

\$800 appraisal fee to determine amount of fire loss.

\$3,000 real estate tax on residence; \$400 state and city sales taxes; \$900 state income tax.

\$100 contribution to a recognized political party.

48. What amount of fire loss were the Hoyts entitled to deduct as an itemized deduction on their 1988 return?

- a. \$5,000
- b. \$2,500
- c. \$1,600
- d. \$1,500

49. What total amount was deductible for taxes on Hoyts' 1988 return?

- a. \$4,300
- b. \$3,900
- c. \$3,400
- d. \$3,000

50. The unreimbursed employee's transportation expenses paid by Sam in 1988 were

- a. Deductible from gross income in arriving at adjusted gross income.
- b. Subject to the 2% of adjusted gross income floor for miscellaneous itemized deductions.
- c. Fully deductible as an itemized deduction.
- d. Not deductible.

51. The appraisal fee to determine the amount of Hoyts' fire loss was

- a. Deductible from gross income in arriving at adjusted gross income.
- b. Subject to the 2% of adjusted gross income floor for miscellaneous itemized deductions.
- c. Deductible after reducing the amount by \$100.
- d. Not deductible.

2N88#13. In 1988, Lyons paid \$3,000 to the tax collector of Maple Township for realty taxes on a two-family house owned by Lyons' mother. Of this amount, \$1,400 covered back taxes for 1987, and \$1,600 was in payment of 1988 taxes. Lyons resides on the second floor of the house, and his mother resides on the first floor. In Lyons' itemized deductions on his 1988 return, what amount may Lyons claim for realty taxes?

- a. \$0
- b. \$1,500
- c. \$1,600
- d. \$3,000

2N88#14. Which one of the following types of itemized deductions is included in the category of unreimbursed expenses that is deductible only if the aggregate amount of such expenses exceeds 2% of the taxpayer's adjusted gross income?

- a. Employee moving expenses.
- b. Tax return preparation fees.
- c. Medical expenses.
- d. Interest expense.

2N88#15. The following information pertains to Cole's personal residence, which sustained casualty fire damage in 1987:

Adjusted basis	\$150,000
Fair market value immediately before the fire	200,000
Fair market value immediately after the fire	180,000
Fire damage repairs paid for by Cole in 1987	10,000

The house was uninsured. Before consideration of any "floor" or other limitation on tax deductibility, the amount of this 1987 casualty loss was

- a. \$30,000
- b. \$20,000
- c. \$10,000
- d. \$0

2M88#7. The unreimbursed 1987 employee travel expenses of an outside salesperson are

- a. Fully deductible from gross income in arriving at adjusted gross income.
- b. Deductible only as miscellaneous itemized deductions subject to a 2% floor.
- c. Fully deductible only as miscellaneous itemized deductions.
- d. Not deductible.

2M88#12. If both a husband and wife are wage earners and file a 1987 joint return, a two-earner wage deduction may be claimed

- a. As an exclusion in arriving at adjusted gross income.
- b. As a special deduction from adjusted gross income.
- c. As a miscellaneous itemized deduction subject to a 2% floor.
- d. Under no circumstances.

2M88#13. The unreimbursed moving expenses of an employee who takes a new job 100 miles away from a previous residence and place of employment are

- a. Fully deductible from gross income in arriving at adjusted gross income.
- b. Deductible only as miscellaneous itemized deductions subject to a 2% floor.
- c. Fully deductible only as miscellaneous itemized deductions.
- d. Not deductible.

Selected Questions

2M88#14. Alan Curtis, who is single, had an adjusted gross income of \$40,000 in 1987, and he used the standard deduction in his 1987 return. During 1987, Alan contributed \$300 to the building fund of State University. What amount was deductible for contributions in Alan's 1987 return?

- a. \$0
- b. \$ 50
- c. \$100
- d. \$300

2M86#53. The zero bracket amount is

- a. The equivalent of the excess itemized deductions.
- b. Built into the tax tables but **not** the tax rate schedules.
- c. Based on the taxpayer's filing status regardless of income.
- d. The amount that determines whether or not an individual is required to file an income tax return.

2M86#56. Gail and Jeff Payne are married and filed a joint return for 1985. In 1985 they paid the following doctors' bills for

Gail's mother, who received over half of her support from Gail and Jeff, but who does **not** live in the Payne household, and who earned \$1,100 in 1985 for baby-sitting. \$700

Their unmarried 26-year old son, who earned \$4,000 in 1985, but was fully supported by his parents. He is **not** a full-time student. 500

Disregarding the adjusted gross income percentage test, how much of these doctors' bills may be included on the Paynes' joint return in 1985 as qualifying medical expenses?

- a. \$0
- b. \$ 500
- c. \$ 700
- d. \$1,200

2M86#57. Medical and dental expenses are deductible only to the extent that they exceed a certain percentage of adjusted gross income. This percentage is

- a. 3%
- b. 5%
- c. 6%
- d. 10%

2M86#60. Edna Green, who is single, had an adjusted gross income of \$30,000 in 1985. Edna contributed \$100 to the alumni fund of State University in 1985, but did

not itemize her deductions for 1985. How much can she deduct for contributions on her 1985 return?

- a. \$0
- b. \$ 25
- c. \$ 50
- d. \$100

2N85

Items 34 through 36 are based on the following data:

During 1984 Burt Knox made the following unreimbursed personal expenditures:

Interest on note payable to a bank; proceeds of loan were used to buy municipal bonds	\$1,000
Payments pertaining to condominium apartment occupied by Burt:	
Interest (\$3,000) and principal (\$2,200) on mortgage	5,200
Realty taxes	1,800
State and city gasoline taxes	150
State hunting license fee	25
Legal fee for preparation of will	100
Education expenses to qualify for new occupation	975

34. How much interest expense should be included in Burt's 1984 itemized deductions?

- a. \$6,200
- b. \$5,200
- c. \$4,000
- d. \$3,000

35. How much should be included in Burt's 1984 itemized deductions for taxes?

- a. \$1,800
- b. \$1,825
- c. \$1,950
- d. \$1,975

36. How much should be included in Burt's 1984 itemized deductions for miscellaneous deductions?

- a. \$1,075
- b. \$ 975
- c. \$ 100
- d. \$0

2N85#37. Edgar Blair, who is single, did not claim any itemized deductions in his 1984 return because the deductions were less than Edgar's zero bracket amount. In 1984 Edgar contributed \$100 to the building fund of his state university. How much was deductible for contributions in Edgar's 1984 return?

- a. \$0
- b. \$ 12.50
- c. \$ 25.00
- d. \$100.00

Accounting Practice

2N85

Items 38 and 39 are based on the following data:

Gene Blake, who is single, had an adjusted gross income of \$50,000 in 1984. During 1984 Gene paid the following unreimbursed medical and dental expenses:

Medical insurance premiums	\$ 300
Dental surgery	5,000

Also in 1984, Gene suffered a \$4,000 loss due to vandalism, for which Gene had no insurance. Gene itemized his deductions for 1984.

38. How much was deductible in Gene's 1984 return for medical and dental expenses?

- a. \$ 150
- b. \$ 300
- c. \$2,800
- d. \$3,800

39. How much was deductible in Gene's 1984 return as a casualty loss?

- a. \$0
- b. \$ 100
- c. \$3,900
- d. \$4,000

2M85

Items 33 through 36* are based on the following data:

Bart Sheen, who is single, itemizes his deductions. The following were among Bart's cash expenditures during 1984:

Interest on bank loan to purchase taxable securities	\$1,000
Finance charges on a revolving charge account at a department store, based on monthly unpaid balances	400
Fourth quarter 1983 estimated state income tax	1,200
City real estate taxes on property owned by Bart and leased to a tenant	3,000
Charitable contributions	5,000
Contribution to candidate for public office	200

34. How much interest expense should Bart include in his schedule of itemized deductions for 1984?

- a. \$0
- b. \$ 400
- c. \$1,000
- d. \$1,400

35. How much should Bart include as taxes in his schedule of itemized deductions for 1984?

- a. \$0
- b. \$1,200
- c. \$3,000
- d. \$4,200

*The items omitted can be found in other Content Specification Groups.

E. Filing Status and Exemptions

2M89

Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:

Sam — age 72; normal vision.
Ann — age 67; legally blind.

Adjusted gross income — \$34,000.

The Hoyts itemized their deductions.

Among the Hoyts' cash receipts during 1988 were the following:

\$1,000 dividends from taxable domestic corporations on stocks held in Sam's name.

\$4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for \$9,000. The Hoyts had no other capital gains or losses in the current or prior years.

\$6,000 first installment on a \$75,000 life insurance policy payable to Ann in annual installments of \$6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts' cash expenditures during 1988 were the following:

\$2,000 transportation expenses required under the terms of Sam's employment contract were paid by Sam, an outside salesman. No reimbursement was received.

\$2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of \$50,000. Fair market value was \$60,000 before the fire and \$55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.

\$800 appraisal fee to determine amount of fire loss.

\$3,000 real estate tax on residence; \$400 state and city sales taxes; \$900 state income tax.

\$100 contribution to a recognized political party.

43. How many personal exemptions were the Hoyts entitled to claim on their 1988 return?

- a. 2
- b. 3
- c. 4
- d. 5

2N88#16. Emil Gow's wife died in 1985. Emil did not remarry, and he continued to maintain a home for himself and his dependent infant child during 1986 and 1987, providing full support for himself and his child during these years. For 1985, Emil properly filed a joint return. For 1987, Emil's filing status is

- a. Single.
- b. Head of household.
- c. Qualifying widower with dependent child.
- d. Married filing joint return.

Selected Questions

2M88#11. Ben and Doris Carr are married and filed a joint 1987 return. Ben is 72 and blind. Doris is 70 and has normal vision. How many personal exemptions may the Carrs claim on their 1987 return?

- a. 2
- b. 3
- c. 4
- d. 5

2N87#17. In 1987, Sam Dunn provided more than half the support for his wife, his father's brother, and his cousin. Sam's wife was the only relative who was a member of Sam's household. None of the relatives had any income, nor did any of them file an individual or a joint return. All of these relatives are U.S. citizens. Which of these relatives should be claimed as a dependent or dependents on Sam's 1987 return?

- a. Only his wife.
- b. Only his father's brother.
- c. Only his cousin.
- d. His wife, his father's brother, and his cousin.

2M86#46. In Mona Lux's 1985 income tax return, Mona validly claimed the \$1,040 personal exemption for her dependent 17-year old son, Brett. Since Brett earned \$5,000 in 1985 selling novelties at the college he attended full time, Brett was also required to file a 1985 income tax return. How much should Brett claim as a personal exemption in his 1985 individual income tax return?

- a. \$0
- b. \$ 520
- c. \$1,000
- d. \$1,040

2M86#59. Nell Brown's husband died in 1982. Nell did not remarry, and continued to maintain a home for herself and her dependent infant child during 1983, 1984, and 1985, providing full support for herself and her child during these three years. For 1982, Nell properly filed a joint return. For 1985, Nell's filing status is

- a. Single.
- b. Married filing joint return.
- c. Head of household.
- d. Qualifying widow with dependent child.

2N85#40. In 1984 Alan Kott provided more than half the support for his following relatives, none of whom qualified as a member of Alan's household:

Cousin
Niece
Foster parent

None of these relatives had any income, nor did any of these relatives file an individual or a joint return. All of these relatives are U.S. citizens. Which of these

relatives could be claimed as a dependent on Alan's 1984 return?

- a. No one.
- b. Niece.
- c. Cousin.
- d. Foster parent.

2M85

Items 25 through 29* are based on the following data:

Emil and Judy Ryan are married and file a joint return. They have no children. Emil is 68 and Judy is 60. They contribute over half of the support for Judy's mother, Cora, age 85, who earned \$800 from baby sitting jobs and received \$1,900 in social security benefits during 1984. Cora lives alone in her own apartment.

Emil earned a salary of \$60,000 in 1984 from his job at Korma Corp., where Emil is covered by his employer's pension plan. Judy, who worked part-time in 1984 and earned \$1,000, is not covered by an employer's pension plan. Other items received jointly by Emil and Judy in 1984 were as follows:

Life insurance proceeds on the death of an unrelated friend	\$8,000
Interest on income tax refund	100
Interest on life insurance policy's accumulated dividends	300
Dividends on stock of a Swiss corporation	500
Dividend on life insurance policy	200

25. How many exemptions should be claimed by the Ryans for 1984?

- a. Two
- b. Three
- c. Four
- d. Five

2M85#30. Sara Hance, who is single and lives alone in Idaho, has no income of her own and is supported in full by the following persons:

	<i>Amount of support</i>	<i>Percent of total</i>
Alma (an unrelated friend)	\$2,400	48
Ben (Sara's brother)	2,150	43
Carl (Sara's son)	450	9
	<u>\$5,000</u>	<u>100</u>

Under a multiple support agreement, Sara's dependency exemption can be claimed by

- a. No one.
- b. Alma.
- c. Ben.
- d. Carl.

*The items omitted can be found in other Content Specification Groups.

F. Tax Computations and Credits

2M89

Items 43 through 51* are based on the following selected 1988 information pertaining to Sam and Ann Hoyt, who filed a joint federal income tax return for the calendar year 1988:

Sam — age 72; normal vision.
Ann — age 67; legally blind.

Adjusted gross income — \$34,000.

The Hoyts itemized their deductions.

Among the Hoyts' cash receipts during 1988 were the following:

\$1,000 dividends from taxable domestic corporations on stocks held in Sam's name.

\$4,000 net proceeds from sale of 100 shares of listed corporation stock bought in 1980 for \$9,000. The Hoyts had no other capital gains or losses in the current or prior years.

\$6,000 first installment on a \$75,000 life insurance policy payable to Ann in annual installments of \$6,000 each over a 15-year period, as beneficiary of the policy on her uncle, who died in 1987.

Among the Hoyts' cash expenditures during 1988 were the following:

\$2,000 transportation expenses required under the terms of Sam's employment contract were paid by Sam, an outside salesman. No reimbursement was received.

\$2,500 repairs in connection with 1988 fire damage to the Hoyt residence. This property has a basis of \$50,000. Fair market value was \$60,000 before the fire and \$55,000 after the fire. Insurance on the property had lapsed in 1987 for nonpayment of premium.

\$800 appraisal fee to determine amount of fire loss.

\$3,000 real estate tax on residence; \$400 state and city sales taxes; \$900 state income tax.

\$100 contribution to a recognized political party.

47. What amount of the \$100 political contribution were the Hoyts entitled to claim as a credit against their 1988 tax?

- a. \$0
- b. \$ 25
- c. \$ 50
- d. \$100

2M89#53. If a taxpayer qualifies for the earned income credit, such credit may

- a. Be carried back or forward if unused.
- b. Be subtracted from adjusted gross income to arrive at taxable income.
- c. Result in a refund even if the taxpayer had no tax withheld from wages.
- d. Result in a refund only if the taxpayer had tax withheld from wages.

2M88#8. The maximum allowable credit for political contributions on a 1987 joint return is

- a. \$100
- b. \$ 50
- c. \$ 25
- d. \$0

2M88#10. An employee who has had social security tax withheld in an amount greater than the maximum for a particular year, may claim

- a. The excess as a credit against income tax, if that excess was withheld by one employer.
- b. The excess as a credit against income tax, if that excess resulted from correct withholding by two or more employers.
- c. Reimbursement of such excess from his employers if that excess resulted from correct withholding by two or more employers.
- d. Such excess as either a credit or an itemized deduction, at the election of the employee, if that excess resulted from correct withholding by two or more employers.

2M86#43. If a taxpayer qualifies for the earned income credit, such credit can be subtracted from

- a. Gross income to arrive at adjusted gross income.
- b. Adjusted gross income to arrive at taxable income after personal exemptions.
- c. The tax owed, or can result in a refund, but only if the taxpayer had tax withheld from wages.
- d. The tax owed, or can result in a refund, even if the taxpayer had no tax withheld from wages.

2N85#30. Dan Olsen's 1984 taxable income was \$75,000. In computing his 1984 federal income tax, Dan was required to use the

- a. Tax Table only if he wanted to use income averaging.
- b. Tax Table even if he did not use income averaging.
- c. Tax Rate Schedule only if he wanted to use income averaging.
- d. Tax Rate Schedule even if he did not use income averaging.

2M85

Items 33 through 36* are based on the following data:

Bart Sheen, who is single, itemizes his deductions. The following were among Bart's cash expenditures during 1984:

Interest on bank loan to purchase taxable securities	\$1,000
Finance charges on a revolving charge account at a department store, based on monthly unpaid balances	400

*The items omitted can be found in other Content Specification Groups.

Selected Questions

Fourth quarter 1983 estimated state income tax	1,200
City real estate taxes on property owned by Bart and leased to a tenant	3,000
Charitable contributions	5,000
Contribution to candidate for public office	200

36. How much should Bart include for political contributions in his schedule of itemized deductions for 1984?

- a. \$0
- b. \$ 50
- c. \$100
- d. \$200

G. Statute of Limitations

2M89#56. On April 15, 1989, a married couple filed their joint 1988 calendar-year return showing gross income of \$80,000. Their return had been prepared by a professional tax preparer who mistakenly omitted \$30,000 of income which, in good faith, the preparer considered to be nontaxable. No information with regard to this omitted income was disclosed on the return or attached statements. By what date must the Internal Revenue Service assert a notice of deficiency before the statute of limitations expires?

- a. December 31, 1991.
- b. April 15, 1992.
- c. December 31, 1994.
- d. April 15, 1995.

2N87#15. If a taxpayer omits from his or her income tax return an amount that exceeds 25% of the gross income reported on the return, the Internal Revenue Service can issue a notice of deficiency within a maximum period of

- a. 3 years from the date the return was filed, if filed before the due date.
- b. 3 years from the date the return was due, if filed by the due date.
- c. 6 years from the date the return was filed, if filed before the due date.
- d. 6 years from the date the return was due, if filed by the due date.

2N87#16. Ben Carr, a calendar-year taxpayer, was 65 years old on December 30, 1986. Ben filed his 1986 individual income tax return on April 1, 1987, and attached a check for the balance of tax due as shown on the return. On August 15, 1987, Ben realized that he had inadvertently failed to claim the additional exemption to which he was entitled by virtue of having attained age 65 in 1986. In order for Ben to recover the tax that he would have saved by claiming the extra exemption, he must file a refund claim no later than

- a. December 31, 1987.
- b. April 1, 1990.
- c. April 15, 1990.
- d. August 15, 1990.

2N85#23. Leo Mann, a calendar-year taxpayer, filed his 1984 individual income tax return on March 15, 1985, and attached a check for the balance of tax due as shown on the return. On June 15, 1985, Leo discovered that he had failed to include, in his itemized deductions, \$1,000 interest on his home mortgage. In order for Leo to recover the tax that he would have saved by utilizing the \$1,000 deduction, he must file an amended return no later than

- a. December 31, 1987.
- b. March 15, 1988.
- c. April 15, 1988.
- d. June 15, 1988.

H. Estate and Gift Taxation and Income Taxation of Estates and Trusts

2M89#57. If no extensions of time for filing were granted, within how many months after the date of a decedent's death is the required federal estate tax return due?

- a. 3½
- b. 4½
- c. 6
- d. 9

2M89#58. If an individual donor makes a gift of future interest whereby the donee is to receive possession of the gift at some future time, the annual exclusion for gift tax purposes is

- a. \$0
- b. \$ 3,000
- c. \$ 5,000
- d. \$10,000

2M89#59. Eng and Lew, both U.S. citizens, died in 1989. Eng made taxable lifetime gifts of \$100,000 that are not included in Eng's gross estate. Lew made no lifetime gifts. At the dates of death, Eng's gross estate was \$300,000, and Lew's gross estate was \$400,000. A federal estate tax return must be filed for

	<u>Eng</u>	<u>Lew</u>
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

2M89#60. With regard to the federal estate tax, the alternate valuation date

- a. Is required to be used if the fair market value of the estate's assets has increased since the decedent's date of death.
- b. If elected on the first return filed for the estate, may be revoked in an amended return provided that the first return was filed on time.
- c. Must be used for valuation of the estate's liabilities if such date is used for valuation of the estate's assets.
- d. Can be elected only if its use decreases both the value of the gross estate and the estate tax liability.

Accounting Practice

2N88#17. Raff created a joint bank account for himself and his friend's son, Dave. There is a gift to Dave when

- a. Raff creates the account.
- b. Raff dies.
- c. Dave draws on the account for his own benefit.
- d. Dave is notified by Raff that the account has been created.

2N88#18. Proceeds of a life insurance policy payable to the estate's executor, as the estate's representative, are

- a. Includible in the decedent's gross estate only if the premiums had been paid by the insured.
- b. Includible in the decedent's gross estate only if the policy was taken out within three years of the insured's death under the "contemplation of death" rule.
- c. Always includible in the decedent's gross estate.
- d. Never includible in the decedent's gross estate.

2N88#19. Ross, a calendar-year, cash basis taxpayer who died in June 1988, was entitled to receive a \$10,000 accounting fee that had not been collected before the date of death. The executor of Ross' estate collected the full \$10,000 in July 1988. This \$10,000 should appear in

- a. Only the decedent's final individual income tax return.
- b. Only the estate's fiduciary income tax return.
- c. Only the estate tax return.
- d. Both the fiduciary income tax return and the estate tax return.

2N88#20. In 1987, Blum, who is single, gave an outright gift of \$50,000 to a friend, Gould, who needed the money to pay medical expenses. In filing the 1987 gift tax return, Blum was entitled to a maximum exclusion of

- a. \$20,000
- b. \$10,000
- c. \$ 3,000
- d. \$0

2M88#17. All trusts, except tax exempt trusts,

- a. Must adopt a calendar year, except for existing trusts with fiscal years ended in 1987.
- b. May adopt a calendar year or any fiscal year.
- c. Must adopt a calendar year regardless of the year the trust was established.
- d. Must use the same taxable year as that of its principal beneficiary.

2M88#18. For income tax purposes, all estates

- a. Must adopt a calendar year, except for existing estates with fiscal years ended in 1987.
- b. May adopt a calendar year or any fiscal year.

- c. Must adopt a calendar year regardless of the year the estate was established.
- d. Must use the same taxable year as that of its principal beneficiary.

2M88#19. With regard to estimated income tax, estates

- a. Must make quarterly estimated tax payments starting no later than the second quarter following the one in which the estate was established.
- b. Are exempt from paying estimated tax during the estate's first two taxable years.
- c. Must make quarterly estimated tax payments only if the estate's income is required to be distributed currently.
- d. Are **not** required to make payments of estimated tax.

2M88#20. A complex trust is a trust that

- a. Must distribute income currently, but is prohibited from distributing principal during the taxable year.
- b. Invests only in corporate securities and is prohibited from engaging in short-term transactions.
- c. Permits accumulation of current income, provides for charitable contributions, or distributes principal during the taxable year.
- d. Is exempt from payment of income tax since the tax is paid by the beneficiaries.

2N87

Items 11 through 13 are based on the following data:

Alan Curtis, a U.S. citizen, died on March 1, 1987, leaving an adjusted gross estate with a fair market value of \$1,400,000 at the date of death. Under the terms of Alan's will, \$375,000 was bequeathed outright to his widow, free of all estate and inheritance taxes. The remainder of Alan's estate was left to his mother. Alan made no taxable gifts during his lifetime.

11. Disregarding extensions of time for filing, within how many months after the date of Alan's death is the federal estate tax return due?

- a. 2½
- b. 3½
- c. 9
- d. 12

12. In computing the taxable estate, the executor of Alan's estate should claim a marital deduction of

- a. \$ 250,000
- b. \$ 375,000
- c. \$ 700,000
- d. \$1,025,000

13. If the executor of Alan's estate elects the alternate valuation method, all remaining undistributed property

Selected Questions

included in the gross estate must be valued as of how many months after Alan's death?

- a. 12
- b. 9
- c. 6
- d. 3

2N87#14. Smith and Jones, both U.S. citizens, died in 1987. Neither made any lifetime gifts. At the dates of death, Smith's gross estate was \$510,000, and Jones' gross estate was \$610,000. A federal estate tax return must be filed for

	<u>Smith</u>	<u>Jones</u>
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

2M86

Items 47 and 48 are based on the following data:

On July 31, 1985, Kim Reed received listed stock as an inheritance from her mother, Nora, who died on January 1, 1985. Nora's adjusted basis for this stock was \$50,000. This stock had a fair market value of \$60,000 on January 1, 1985, and \$65,000 on July 31, 1985. The alternate valuation was **not** elected. Kim's adjusted gross income for 1985 was \$20,000 before any consideration of her inheritance.

47. How much should Kim report in her 1985 return as adjusted gross income?

- a. \$20,000
- b. \$70,000
- c. \$80,000
- d. \$85,000

48. Kim's basis for the inherited stock is

- a. \$0
- b. \$50,000
- c. \$60,000
- d. \$65,000

2N85#29. Fred Zorn died on January 5, 1985, bequeathing his entire \$2,000,000 estate to his sister, Ida. The alternate valuation date was validly elected by the executor of Fred's estate. Fred's estate included 2,000 shares of a listed stock for which Fred's basis was \$380,000. This stock was distributed to Ida nine months after Fred's death. Fair market values of this stock were:

At the date of Fred's death	\$400,000
Six months after Fred's death	450,000
Nine months after Fred's death	480,000

Ida's basis for this stock is

- a. \$380,000
- b. \$400,000
- c. \$450,000
- d. \$480,000

2N85#32. In January 1982, Kirk Kelly bought 100 shares of a listed stock for \$8,000. In March 1983, when the fair market value was \$6,000, Kirk gave this stock to his cousin, Clara. No gift tax was paid. Clara sold this stock in June 1985 for \$7,000. How much is Clara's reportable gain or loss in 1985 on the sale of this stock?

- a. \$0.
- b. \$1,000 loss.
- c. \$1,000 gain.
- d. \$7,000 gain.

2M85

Items 25 through 29* are based on the following data:

Emil and Judy Ryan are married and file a joint return. They have no children. Emil is 68 and Judy is 60. They contribute over half of the support for Judy's mother, Cora, age 85, who earned \$800 from baby sitting jobs and received \$1,900 in social security benefits during 1984. Cora lives alone in her own apartment.

Emil earned a salary of \$60,000 in 1984 from his job at Korma Corp., where Emil is covered by his employer's pension plan. Judy, who worked part-time in 1984 and earned \$1,000, is not covered by an employer's pension plan. Other items received jointly by Emil and Judy in 1984 were as follows:

Life insurance proceeds on the death of an unrelated friend	\$8,000
Interest on income tax refund	100
Interest on life insurance policy's accumulated dividends	300
Dividends on stock of a Swiss corporation	500
Dividend on life insurance policy	200

27. How much of the life insurance proceeds should be reported by the Ryans in their 1984 return?

- a. \$0
- b. \$3,000
- c. \$5,000
- d. \$8,000

2M85

Items 38 through 40* are based on the following data:

On July 1, 1984, Kim Wald sold an antique for \$15,000 that she had bought for her personal use in 1981 at a cost of \$12,000. Also on July 1, 1984, Kim sold 100 shares of Ral Corp. stock. Kim had received this stock on March 1, 1984, as a bequest from the estate of John Wolf who died on January 2, 1984, when this stock had a fair market value of \$8,000. The executor of John's estate did not elect the alternate valuation. John had bought this stock in 1970 for \$1,000.

39. Kim's basis for the 100 shares of Ral stock was

- a. \$0
- b. \$ 1,000
- c. \$ 8,000
- d. \$10,000

*The items omitted can be found in other Content Specification Groups.

X. Federal Taxation — Corporations, Partnerships, and Exempt Organizations

A. Determination of Taxable Income or Loss

2N88#22. The following information pertains to treasury stock sold by Lee Corp. to an unrelated broker in 1987:

Proceeds received	\$50,000
Cost	30,000
Par value	9,000

What amount of capital gain should Lee recognize in 1987 on the sale of this treasury stock?

- a. \$0
- b. \$ 8,000
- c. \$20,000
- d. \$30,500

2N88#23. A corporation's tax preference items that must be taken into account for 1988 alternative minimum tax purposes include

- a. Use of the percentage-of-completion method of accounting for long-term contracts.
- b. Casualty losses.
- c. Accelerated depreciation on pre-1987 real property to the extent of the excess over straight-line depreciation.
- d. Capital gains.

2N88#24. In 1988, Kara Corp. incurred the following expenditures in connection with the repurchase of its stock from shareholders to avert a hostile takeover:

Interest on borrowings used to repurchase stock	\$100,000
Legal and accounting fees in connection with the repurchase	400,000

The total of the above expenditures deductible in 1988 is

- a. \$0
- b. \$100,000
- c. \$400,000
- d. \$500,000

2N88#28. Dana Corp. owns stock in Seco Corp. For Dana and Seco to qualify for the filing of consolidated returns, at least what percentage of Seco's total voting power and total value of stock must be directly owned by Dana?

	<u>Total voting power</u>	<u>Total value of stock</u>
a.	51%	51%
b.	51%	80%
c.	80%	51%
d.	80%	80%

2M88#22. During 1987, Ral Corp. exchanged 5,000 shares of its own \$10 par common stock for land with a fair market value of \$75,000. As a result of this exchange, Ral should report in its 1987 tax return

- a. \$25,000 Section 1245 gain.
- b. \$25,000 Section 1231 gain.
- c. \$25,000 ordinary income.
- d. No gain.

2M88#23. During 1987, Marb Corp. had net long-term capital losses of \$7,000, net short-term capital gains of \$3,000, gains of \$1,500 on the sale of Section 1231 property, and losses of \$2,000 on the sale of Section 1245 property. There was no capital loss carryforward from prior years. The capital gains deduction for 1987 was

- a. \$0
- b. \$1,000
- c. \$1,500
- d. \$4,500

2M88#24. If a corporation's charitable contributions exceed the limitation for deductibility in a particular year, the excess

- a. May be carried back to the third preceding year.
- b. May be carried forward to a maximum of five succeeding years.
- c. May be carried back or forward for one year at the corporation's election.
- d. Is not deductible in any future or prior year.

2M88#25. With regard to the deduction for bad debts in 1988, corporations that are not financial institutions

- a. May take a deduction for a reasonable addition to a "reserve" for bad debts, if the reserve method was consistently used in prior years.
- b. May change from the direct charge-off method to the reserve method, if approval is requested from the IRS.
- c. Must use the direct charge-off method rather than the reserve method.
- d. May elect either the reserve method or the direct charge-off method, if the election is made in the corporation's first taxable year.

2M88#26. In 1987, Roe Corp. purchased and placed in service a machine to be used in its manufacturing operations. This machine cost \$201,000. What portion of the cost may Roe elect to treat as an expense rather than as a capital expenditure?

- a. \$0
- b. \$ 9,000
- c. \$10,000
- d. \$20,100

Selected Questions

2M88#27. For the year ended December 31, 1987, Dodd Corp. had net income per books of \$100,000. Included in the computation of net income were the following items:

Provision for federal income tax	\$27,000
Net long-term capital loss	5,000
Keyman life insurance premiums (corporation is beneficiary)	3,000

Dodd's 1987 taxable income was

- a. \$127,000
- b. \$130,000
- c. \$132,000
- d. \$135,000

2M88#28. Consolidated returns may be filed

- a. Either by parent-subsidiary corporations or by brother-sister corporations.
- b. Only by corporations that formally request advance permission from the IRS.
- c. Only by parent-subsidiary affiliated groups.
- d. Only by corporations that issue their financial statements on a consolidated basis.

2N87

Items 21 through 26 are based on the following data:

Eric Bay was the sole stockholder of Lee Corp., an accrual basis taxpayer engaged principally in retailing operations. Lee's retained earnings at December 31, 1986, amounted to \$2,000,000. For the year ended December 31, 1987, Lee's book income, before income taxes, was \$600,000. Included in the computation of this \$600,000 were the following:

Gain on sale of land used in business	\$ 20,000
Loss on sale of long-term investments in marketable securities	30,000

Dividend income from unaffiliated taxable domestic corporations	4,000
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Keyman insurance premiums paid on Bay's life (Lee is beneficiary)	1,000
---	-------

Group term life insurance premiums paid on \$25,000 life insurance policies for employees (employees' dependents are beneficiaries)	15,000
---	--------

Contribution to State University (authorized by Board of Directors in December 1987; to be paid March 3, 1988)	100,000
--	---------

Amortization of organization costs (total organization costs of \$6,000 were incurred in January 1984, and are being amortized over a 10-year period for financial statement purposes)	600
--	-----

In 1980, Lee had reacquired 1,000 shares of its own \$10 par common stock at a cost of \$25,000. This stock was held as treasury stock until May 1987, when it was reissued to James Smith at its fair market value of \$33,000.

21. In computing taxable income for 1987, Lee should deduct a net capital loss of
- a. \$15,000
 - b. \$10,000
 - c. \$ 5,000
 - d. \$0

22. The dividend income Lee should include in its 1987 taxable income is
- a. \$4,000
 - b. \$3,200
 - c. \$ 800
 - d. \$0

23. In computing taxable income for 1987, what amount should Lee deduct for keyman and group life insurance premiums?
- a. \$ 8,000
 - b. \$15,000
 - c. \$15,500
 - d. \$16,000

24. With regard to Lee's contribution to State University, Lee can
- a. Not deduct any portion of the \$100,000 in 1987, because the contribution was not paid until 1988.
 - b. Deduct the entire \$100,000 in its 1987 return.
 - c. Elect to carry back to 1986 a portion of the \$100,000 that does not exceed the deduction ceiling for 1986 and 1987.
 - d. Elect to deduct in its 1987 return any portion of the \$100,000 that does not exceed the deduction ceiling for 1987.

25. In computing taxable income for 1987, what is the maximum deduction that Lee can claim for organization costs, assuming that the appropriate election was made on a timely basis?
- a. \$1,200
 - b. \$ 600
 - c. \$ 300
 - d. \$0

26. How much should Lee report in its 1987 return as long-term capital gain on the issuance of its treasury stock to Smith?
- a. \$0
 - b. \$ 8,000
 - c. \$23,000
 - d. \$33,000

2N87#28. For the year ended December 31, 1987, Bard Corp.'s income per accounting records, before

Accounting Practice

federal income taxes, was \$450,000 and included the following:

State corporate income tax refunds	\$ 4,000
Life insurance proceeds on officer's death	15,000
Net loss on sale of securities bought for investment in 1976	20,000

Bard's 1987 taxable income was

- a. \$435,000
- b. \$451,000
- c. \$455,000
- d. \$470,000

2N87#29. In the filing of a consolidated income tax return for a corporation and its wholly-owned subsidiaries, intercompany dividends between the parent and subsidiary corporations are

- a. Fully taxable.
- b. Included in taxable income to the extent of 80%.
- c. Included in taxable income to the extent of 20%.
- d. Not taxable.

2M87#42. For the year ended December 31, 1987, Sol Corp. had an operating income of \$20,000. In addition, Sol had capital gains and losses resulting in a net short-term capital gain of \$2,000 and a net long-term capital loss of \$7,000. How much of the excess of net long-term capital loss over net short-term capital gain could Sol offset against ordinary income for 1987?

- a. \$5,000
- b. \$3,000
- c. \$1,500
- d. \$0

2M87#46. Which one of the following is a capital asset?

- a. Delivery truck.
- b. Goodwill.
- c. Land used as a parking lot for customers.
- d. Treasury stock, at cost.

2M87

Items 47 through 49 are based on the following data:

Ram Corp.'s operating income for the year ended December 31, 1987 amounted to \$100,000. In addition, Ram received \$2,000 in dividends from an unrelated taxable domestic corporation in 1987. Included in Ram's 1987 operating expenses is a \$6,000 insurance premium on a policy insuring the life of Ram's president. Ram is beneficiary of this policy. Also in 1987, a machine owned by Ram was completely destroyed in an accident. This machine's adjusted basis immediately before the casualty was \$15,000. The machine was not insured and had no salvage value.

47. In Ram's 1987 tax return, what amount should be included in taxable income for the dividends?

- a. \$ 300
- b. \$ 400
- c. \$1,600
- d. \$1,700

48. In Ram's 1987 tax return, what amount should be deducted for the \$6,000 life insurance premium?

- a. \$6,000
- b. \$5,000
- c. \$1,000
- d. \$0

49. In Ram's 1987 tax return, what amount should be deducted for the casualty loss?

- a. \$ 5,000
- b. \$ 5,400
- c. \$14,900
- d. \$15,000

2M87#50. For the first taxable year in which a corporation has qualifying research and experimental expenditures, the corporation

- a. Has a choice of either deducting such expenditures as current business expenses, or capitalizing these expenditures.
- b. Has to treat such expenditures in the same manner as they are accounted for in the corporation's financial statements.
- c. Is required to deduct such expenditures currently as business expenses or lose the deductions.
- d. Is required to capitalize such expenditures and amortize them ratably over a period of not less than 60 months.

2N86#41. Al Eng owns 55% of the outstanding stock of Rego Corp. During 1986, Rego sold a trailer to Eng for \$10,000. The trailer had an adjusted tax basis of \$12,000, and had been owned by Rego for three years. In its 1986 income tax return, what is the allowable loss that Rego can claim on the sale of this trailer?

- a. \$0.
- b. \$2,000 ordinary loss.
- c. \$2,000 Section 1231 loss.
- d. \$2,000 Section 1245 loss.

2N86#42. In 1985, Nam Corp., which is not a dealer in securities, realized taxable income of \$160,000 from its business operations. Also in 1985, Nam sustained a long-term capital loss of \$24,000 from the sale of marketable securities. Nam did not realize any other capital gains or losses since it began operations. In Nam's income tax returns, what is the proper treatment for the \$24,000 long-term capital loss?

- a. Use \$3,000 of the loss to reduce 1985 taxable income, and carry \$21,000 of the long-term capital loss forward for five years.

Selected Questions

- b. Use \$6,000 of the loss to reduce 1985 taxable income by \$3,000, and carry \$18,000 of the long-term capital loss forward for five years.
- c. Use \$24,000 of the long-term capital loss to reduce 1985 taxable income by \$12,000.
- d. Carry the \$24,000 long-term capital loss forward for five years, treating it as a short-term capital loss.

2N86#44. In 1985, Daly Corp. had the following income:

Profit from operations	\$100,000
Dividends from unrelated taxable domestic corporation	1,000

In Daly's 1985 taxable income, how much should be included for the dividends received?

- a. \$0
- b. \$ 150
- c. \$ 850
- d. \$1,000

2N86#48. Parent Corp. and Subsidiary Corp. file consolidated returns on a calendar-year basis. In January 1985, Subsidiary sold land, which it had used in its operations, to Parent for \$75,000. Immediately before this sale, Subsidiary's basis for the land was \$45,000. Parent held the land primarily for sale to customers in the ordinary course of business. In July 1986, Parent sold the land to Dubin, an unrelated individual, for \$90,000. In determining the consolidated Section 1231 net gain for 1986, how much should Subsidiary take into account as a result of the 1985 sale of the land from Subsidiary to Parent?

- a. \$45,000
- b. \$30,000
- c. \$22,500
- d. \$15,000

2N86#49. For the year ended December 31, 1985, Kork Corp.'s book income, before federal income taxes, was \$300,000. Included in this \$300,000 were the following items:

Provision for state corporation income tax	\$3,000
Interest income on United States obligations	8,000
Interest paid on loan to carry United States obligations	2,000

How much was Kork's 1985 taxable income?

- a. \$292,000
- b. \$294,000
- c. \$300,000
- d. \$303,000

2N86#51. Moss Corp.'s income statement for 1985 showed the following expenses for life insurance premiums:

Group-term life insurance premiums paid on employees' lives, with the employees' dependents as beneficiaries	\$10,000
--	----------

Term life insurance premiums paid on life of Moss' president, with Moss Corp. as beneficiary	7,000
--	-------

On its 1985 tax return, how much should Moss deduct for life insurance premiums?

- a. \$0
- b. \$ 7,000
- c. \$10,000
- d. \$17,000

2N86

Items 59 and 60 are based on the following data:

Blu Corp. had operating income of \$80,000, after deducting \$5,000 for contributions to the state university, but not including dividends of \$1,000 received from nonaffiliated taxable domestic corporations.

59. In computing the maximum allowable deduction for contributions, how much is the base amount to which Blu should apply the percentage limitation?

- a. \$81,000
- b. \$85,000
- c. \$85,150
- d. \$86,000

60. In applying the percentage limitation to the base amount, in order to compute the maximum allowable deduction for contributions, what percentage should Blu use?

- a. 5%
- b. 10%
- c. 30%
- d. 50%

2N85#44. Cava Corp., which has no portfolio indebtedness, received the following dividends in 1984:

From a mutual savings bank	\$1,500
From an unaffiliated domestic taxable corporation	7,500

How much of these dividends qualifies for the 85% dividends-received deduction?

- a. \$9,000
- b. \$7,500
- c. \$1,500
- d. \$0

Accounting Practice

- 2N85#45.** Which of the following is a capital asset?
- Machinery used in manufacturing a product.
 - Treasury stock.
 - Goodwill.
 - Real estate used in business operations.

2N85#46. During 1984 Ati Corp. had net long-term capital losses of \$28,000, net short-term capital gains of \$12,000, gains on the sale of Section 1231 property of \$6,000, and losses on the sale of Section 1245 property of \$8,000. There was no capital loss carryforward from prior years. How much was the capital gains deduction for 1984?

- \$18,000
- \$ 7,200
- \$ 4,800
- \$0

2N85#47. Thor Corporation's operating income for 1984 was \$300,000, after consideration of \$50,000 for charitable contributions. What was the maximum allowable deduction for contributions in Thor's 1984 return?

- \$35,000
- \$30,000
- \$17,500
- \$15,000

2N85#48. If a corporation's charitable contributions exceed the limitation for deductibility in a particular year, such excess

- Is **not** deductible in any future year.
- Becomes a carryover to a maximum of 5 succeeding years.
- May be carried back to the third preceding year.
- Reduces the corporation's capital loss carry-back for that year.

2N85#49. In the reconciliation of income per books with income per return

- Only timing differences are considered.
- Only permanent differences are considered.
- Both timing and permanent differences are considered.
- Neither timing nor permanent differences are considered.

2N85#50. The filing of consolidated returns is available

- Only to parent-subsidiary corporations.
- Only to brother-sister corporations.
- Either to parent-subsidiary corporations or to brother-sister corporations.
- Neither to parent-subsidiary corporations nor to brother-sister corporations.

2M85#45. The filing of consolidated returns is available only to

- Brother-sister corporations.
- Parent-subsidiary affiliated groups.
- Corporations that formally request advance permission from the IRS.
- Corporations that issue their financial statements on a consolidated basis.

2M85

Items 46 through 52 are based on the following data:

Aki Corp., which was organized on January 2, 1981, had a book income of \$500,000 for the year ended December 31, 1984. The following information was recorded in Aki's books and records during 1984:

Sale of treasury stock to unrelated broker:	
Proceeds received	\$100,000
Cost	70,000
Par value	5,000

Dividends received from unaffiliated taxable domestic corporations	3,000
--	-------

Long-term capital gains on sale of stock of unrelated corporations	12,000
--	--------

Short-term capital losses on sale of stock of unrelated corporations	30,000
--	--------

Sale of land (used in business) to Max Carr, who owns 55% of Aki's outstanding stock, but is neither an officer nor a director of Aki:	
Sales price to Carr	40,000
Adjusted basis to Aki	44,000

Insurance premiums paid on policy insuring the life of Luke Ross, Aki's president (Aki is beneficiary of policy)	9,000
--	-------

Cash dividends paid on outstanding 10% cumulative preferred stock	20,000
---	--------

Interest paid to Ira Farb, who owns 1% of Aki's outstanding stock and is one of Aki's directors (Aki has a note payable to Farb for \$60,000 borrowed from Farb in 1983 at 10% interest)	6,000
--	-------

Amortization of organizational expenditures being written off over a 10-year period for financial statement purposes	1,000
--	-------

46. How much capital gain should Aki report in its 1984 return on the sale of treasury stock?

- \$0
- \$ 5,000
- \$30,000
- \$95,000

Selected Questions

47. Assuming that Aki has no portfolio indebtedness, how much is Aki's dividends-received deduction for 1984?

- a. \$0
- b. \$ 450
- c. \$2,100
- d. \$2,550

48. How much net capital loss can Aki deduct in its 1984 return on the sales of stock of unrelated corporations?

- a. \$0
- b. \$ 7,200
- c. \$18,000
- d. \$24,000

49. What is the allowable loss that Aki can claim in its 1984 return for the sale of land to Max Carr?

- a. \$4,000 Section 1231 loss.
- b. \$4,000 Section 1245 loss.
- c. \$4,000 Section 1250 loss.
- d. \$0.

50. How much can Aki deduct in its 1984 return for the insurance premiums paid on the policy insuring the life of Luke Ross?

- a. \$0
- b. \$4,000
- c. \$5,000
- d. \$9,000

51. How much can Aki deduct in its 1984 return for the dividends paid to preferred stockholders and for the interest paid to Ira Farb?

- a. \$0
- b. \$ 6,000
- c. \$20,000
- d. \$26,000

52. Aki is writing off its organizational expenditures over the minimum allowable period for tax purposes. How much can Aki deduct in its 1984 return for amortization of organizational expenditures?

- a. \$1,000
- b. \$1,500
- c. \$2,000
- d. \$3,000

B. Tax Computations and Credits

2M88#29. Except for transition property, qualified progress expenditures, and qualified timber property, the regular 10% investment tax credit

- a. Is repealed for property placed in service after December 31, 1985.
- b. Can be carried forward up to a maximum of 18 years.

- c. Can be claimed only if the asset's estimated useful life is at least three years.
- d. Is available only if the asset qualifies as five-year accelerated cost recovery system property.

2N87#30. If a corporation's tentative minimum tax exceeds the regular tax, the excess amount is

- a. Carried back to the preceding taxable year.
- b. Carried back to the third preceding taxable year.
- c. Payable in addition to the regular tax.
- d. Subtracted from the regular tax.

2M87#51. A corporation may reduce its income tax by taking a tax credit for

- a. Accelerated depreciation.
- b. State income taxes.
- c. Foreign income taxes.
- d. Dividends-received exclusion.

2N86#43. A corporation may reduce its income tax by taking a tax credit for

- a. Excess charitable contributions.
- b. State income taxes.
- c. Political contributions.
- d. Foreign income taxes.

2N85#51. Of the following tax credits, which one is not available to corporations?

- a. Political contributions.
- b. Employee stock ownership.
- c. Alcohol fuel.
- d. Research.

2N85#55. Reproduced below are the 1984 corporate tax rates:

If the amount on
Form 1120, Line 30,
Page 1 is:

Enter on Form 1120,
Schedule J, Line 3:

Over—	But not over—		Of the amount over—
0	\$ 25,000	15%	0
\$ 25,000	50,000	\$ 3,750 + 18%	\$ 25,000
50,000	75,000	8,250 + 30%	50,000
75,000	100,000	15,750 + 40%	75,000
100,000	-----	25,750 + 46%	100,000

Mason Corporation's 1984 taxable income was \$80,000. Mason's 1984 tax was

- a. \$13,750
- b. \$15,750
- c. \$17,250
- d. \$17,750

C. S Corporations

2N88#25. An S corporation's accumulated adjustments account, which measures the amount of earnings that may be distributed tax-free,

- Must be adjusted downward for the full amount of federal income taxes attributable to any taxable year in which the corporation was a C corporation.
- Must be adjusted upward for the full amount of federal income taxes attributable to any taxable year in which the corporation was a C corporation.
- Must be adjusted upward or downward for only the federal income taxes affected by capital gains or losses, respectively, for any taxable year in which the corporation was a C corporation.
- Is **not** adjusted for federal income taxes attributable to a taxable year in which the corporation was a C corporation.

2M88#30. To be eligible for S corporation status, a corporation can

- Not have a decedent's estate as a stockholder.
- Not have a bankruptcy estate as a stockholder.
- Have both voting and nonvoting common stock issued and outstanding.
- Not have more than 25 stockholders.

2N87#27. Tau Corp., which has been operating since 1980, has an October 31 year end, which coincides with its natural business year. On May 15, 1987, Tau filed the required form to elect S corporation status. All of Tau's stockholders consented to the election, and all other requirements were met. The earliest date that Tau can be recognized as an S corporation is

- November 1, 1986.
- May 15, 1987.
- November 1, 1987.
- November 1, 1988.

2M87#43. Bow, Inc., an S corporation, has three equal stockholders. For the year ended December 31, 1987, Bow had taxable income and current earnings and profits of \$300,000. Bow made cash distributions totaling \$120,000 during 1987. For 1987, what amount from Bow should be included in each stockholder's gross income?

- \$140,000
- \$100,000
- \$ 60,000
- \$ 40,000

2N86#50. What is the maximum number of stockholders allowable for eligibility as an S corporation?

- 5
- 15
- 25
- 35

2N86# 58. With regard to S corporations and their stockholders, the "at-risk" rules applicable to losses

- Apply at the shareholder level rather than at the corporate level.
- Depend on the number of persons owning the S corporation's stock.
- Take into consideration the character of the S corporation's income.
- Are subject to the elections made by the S corporation's stockholders.

2N85#41. Poe Corp. was organized in 1985 with the intention of operating as an S corporation. What is the maximum number of stockholders allowable for eligibility as an S corporation?

- 5
- 15
- 25
- 35

2N85#42. If a calendar-year S corporation does **not** request an automatic six-month extension of time to file its income tax return, the return is due by

- January 31
- March 15
- April 15
- June 30

2N85#43. An S corporation is **not** permitted to take a deduction for

- Compensation of officers.
- Interest paid to individuals who are **not** stockholders of the S corporation.
- Charitable contributions.
- Employee benefit programs established for individuals who are **not** stockholders of the S corporation.

2M85#55. For the year ended December 31, 1984, Elk Inc., an S corporation, had net income per books of \$54,000, which included \$45,000 from operations and a \$9,000 net long-term capital gain. During 1984, \$22,500 was distributed to Elk's three equal stockholders, all of whom are on a calendar-year basis. On what amounts should Elk compute its income and capital gain taxes?

	<u>Ordinary income</u>	<u>Long-term capital gain</u>
a.	\$31,500	\$0
b.	\$22,500	\$0
c.	\$0	\$9,000
d.	\$0	\$0

D. Personal Holding Companies

2N88#29. Benson, a singer, owns 100% of the outstanding capital stock of Lund Corp. Lund contracted with Benson, specifying that Benson was to perform personal services for Magda Productions, Inc., in consideration of which Benson was to receive \$50,000 a

Selected Questions

year from Lund. Lund contracted with Magda, specifying that Benson was to perform personal services for Magda, in consideration of which Magda was to pay Lund \$1,000,000 a year. Personal holding company income will be attributable to

- a. Benson only.
- b. Lund only.
- c. Magda only.
- d. All three contracting parties.

2M88#31. The personal holding company tax

- a. Qualifies as a tax credit that may be used by partners or stockholders to reduce their individual income taxes.
- b. May be imposed on both corporations and partnerships.
- c. Should be self-assessed by filing a separate schedule with the regular tax return.
- d. May be imposed regardless of the number of equal stockholders in a corporation.

2N87#34. The personal holding company tax may be imposed

- a. As an alternative tax in place of the corporation's regularly computed tax.
- b. If more than 50% of the corporation's stock is owned, directly or indirectly, by more than ten stockholders.
- c. If at least 60% of the corporation's adjusted ordinary gross income for the taxable year is personal holding company income, and the stock ownership test is satisfied.
- d. In conjunction with the accumulated earnings tax.

2M87#44. Kee Holding Corp. has 80 unrelated equal stockholders. For the year ended December 31, 1987, Kee's income comprised the following:

Net rental income	\$ 1,000
Commissions earned on sales of franchises	3,000
Dividends from taxable domestic corporations	90,000

Deductible expenses for 1987 totaled \$10,000. Kee paid no dividends for the past three years. Kee's liability for personal holding company tax for 1987 will be based on

- a. \$12,000
- b. \$11,000
- c. \$ 9,000
- d. \$0

2N86#46. Neel Corp. has one preferred stockholder and three common stockholders. Neel derives all of its income from investments in stocks and securities, and regularly distributes 51% of its taxable income as dividends to its stockholders. Neel is a(an)

- a. Regulated investment company.
- b. S corporation.
- c. Corporation subject to the accumulated earnings tax.
- d. Personal holding company.

2M85#44. Where passive investment income is involved, the personal holding company tax may be imposed

- a. On both partnerships and corporations.
- b. On companies whose gross income arises solely from rentals, if the lessors render no services to the lessees.
- c. If more than 50% of the company is owned by five or fewer individuals.
- d. On small business investment companies licensed by the Small Business Administration.

E. Accumulated Earnings Tax

2N87#35. The accumulated earnings tax

- a. Should be self-assessed by filing a separate schedule along with the regular tax return.
- b. Applies only to closely held corporations.
- c. Can be imposed on S corporations that do not regularly distribute their earnings.
- d. Can **not** be imposed on a corporation that has undistributed earnings and profits of less than \$150,000.

2M87#41. The accumulated earnings tax is **not** imposed on corporations that

- a. Are personal holding companies.
- b. Are subsidiary corporations.
- c. Have assets with an aggregate book value of less than \$1,000,000.
- d. Have more than 100 stockholders.

2N86#47. The accumulated earnings tax can be imposed

- a. Regardless of the number of stockholders of a corporation.
- b. On both partnerships and corporations.
- c. On companies that make distributions in excess of accumulated earnings.
- d. Only on parent-subsidiary affiliated groups.

2N85#52. The accumulated earnings tax does **not** apply to

- a. Corporations filing consolidated returns.
- b. Corporations that have preferred stock outstanding.
- c. Personal holding companies.
- d. Corporations that have more than 35 stockholders.

2M85#43. The accumulated earnings tax

- a. Depends on a stock ownership test based on the number of stockholders.
- b. Can be avoided by sufficient dividend distributions.
- c. Is computed by the filing of a separate schedule along with the corporation's regular tax return.
- d. Is imposed when the entity is classified as a personal holding company.

F. Distributions

2M88#31. The following information pertains to Ral Corp.:

Accumulated earnings and profits at January 1, 1987	\$30,000
Earnings and profits for the year ended December 31, 1987	40,000
Cash distributions to individual stockholders in 1987	90,000

What is the total amount of distributions taxable as dividend income to Ral's stockholders in 1987?

- a. \$0
- b. \$40,000
- c. \$70,000
- d. \$90,000

2M87#57. Mem Corp., which had earnings and profits of \$500,000, made a nonliquidating distribution of property to its stockholders in 1987, as a dividend in kind. This property, which had an adjusted basis of \$10,000 and a fair market value of \$15,000 at the date of distribution, did not constitute assets used in the active conduct of Mem's business. How much gain did Mem have to recognize on this distribution?

- a. \$0
- b. \$ 5,000
- c. \$10,000
- d. \$15,000

2M85#53. The following information pertains to Peel Corp.:

Accumulated earnings and profits at January 1, 1984	\$15,000
Earnings and profits for the year ended December 31, 1984	18,000
Dividends distributed to individual shareholders during 1984	52,500

How much of the dividends are taxable as dividend income to Peel's shareholders in 1984 before any available exclusions?

- a. \$15,000
- b. \$18,000
- c. \$33,000
- d. \$52,500

G. Tax-Free Incorporation

2M88#34. In 1987, Dr. James Pyle, a cash basis taxpayer, incorporated his dental practice. No liabilities were transferred. The following assets were transferred to the corporation:

Cash (checking account)	\$1,000
Equipment	
Adjusted basis	60,000
Fair market value	68,000

Immediately after the transfer, Pyle owned 100% of the corporation's stock. The corporation's total basis for the transferred assets is

- a. \$69,000
- b. \$68,000
- c. \$61,000
- d. \$60,000

2M87#45. To qualify for tax-free incorporation, a sole proprietor must be in control of the transferee corporation immediately after the exchange of the proprietorship's assets for the corporation's stock. "Control" for this purpose means ownership of stock amounting to at least

- a. 80.00%
- b. 66.67%
- c. 51.00%
- d. 50.00%

H. Reorganizations

2M88#32. Which one of the following is a corporate reorganization as defined in the Internal Revenue Code?

- a. Mere change in place of organization of one corporation.
- b. Stock redemption.
- c. Change in depreciation method from accelerated to straight-line.
- d. Change in inventory costing method from FIFO to LIFO.

2M88#32. The accumulated earnings tax does not apply to

- a. Corporations that have more than 100 stockholders.
- b. Personal holding companies.
- c. Corporations filing consolidated returns.
- d. Corporations that have more than one class of stock.

2M87#36. Pursuant to a plan of corporate reorganization adopted in June 1987, Lois Pell exchanged 100 shares of Ral Corp. common stock that she had purchased in March 1987 at a cost of \$10,000 for 150 shares of Lars Corp. common stock having a fair market value of \$12,000. Pell's recognized gain on this exchange was

- a. \$0.
- b. \$2,000 ordinary income.
- c. \$2,000 short-term capital gain.
- d. \$2,000 long-term capital gain.

Selected Questions

2M87#58. With regard to corporate reorganizations, which one of the following statements is correct?

- A mere change in identity, form, or place of organization of one corporation does **not** qualify as a reorganization.
- The reorganization provisions can **not** be used to provide tax-free treatment for corporate transactions.
- Securities in corporations **not** parties to a reorganization are always "boot."
- A "party to the reorganization" does **not** include the consolidated company.

2N86#45. Which one of the following is **not** a corporate reorganization as defined in the Internal Revenue Code?

- Stock redemption.
- Recapitalization.
- Mere change in identity.
- Statutory merger.

2M85#54. Pursuant to a plan of corporate reorganization adopted in 1984, Myra Eber exchanged 1,000 shares of Faro Corp. common stock that she had purchased for \$75,000, for 1,800 shares of Judd Corp. common stock having a fair market value of \$86,000. As a result of this exchange, Eber's recognized gain and her basis in the Judd stock should be

	<i>Recognized gain</i>	<i>Basis</i>
a.	\$11,000	\$86,000
b.	\$11,000	\$75,000
c.	\$0	\$86,000
d.	\$0	\$75,000

I. Liquidations and Dissolutions

2N88#33. For the collapsible corporation provisions to be imposed, the holding period of the corporation's stock

- Must be a minimum of six months.
- Must be a minimum of 12 months.
- Depends on the stockholder's basis for gain or loss.
- Is irrelevant.

2M87#59. In 1987, Aca Corp. adopted a plan of complete liquidation. Distributions to stockholders in 1987, under this plan of complete liquidation, included marketable securities purchased in 1980 with a basis of \$100,000 and a fair market value of \$120,000 at the date of distribution. On June 30, 1987, the date this plan of complete liquidation was adopted, Aca had 100 equal stockholders, and the fair market value of all of Aca's outstanding stock was \$12,000,000. In Aca's 1987 return, what amount should be reported as long-term capital gain?

- \$20,000
- \$10,000
- \$ 8,000
- \$0

2N85#54. When a parent corporation completely liquidates its 80%-owned subsidiary, the parent (as stockholder) will ordinarily

- Be subject to capital gains tax on 80% of the long-term gain.
- Be subject to capital gains tax on 100% of the long-term gain.
- Have to report any gain on liquidation as ordinary income.
- Not recognize gain or loss on the liquidating distributions.

2M85#42. Lark Corp. and its wholly-owned subsidiary, Day Corp., both operated on a calendar year. In January 1984 Day adopted a plan of complete liquidation. Two months later, Day paid all of its liabilities and distributed its remaining assets to Lark. These assets consisted of the following:

Cash	\$50,000
Land (at cost)	10,000

Fair market value of the land was \$30,000. Upon distribution of Day's assets to Lark, all of Day's capital stock was cancelled. Lark's basis for the Day stock was \$7,000. Lark's recognized gain in 1984 on receipt of Day's assets in liquidation was

- \$0
- \$50,000
- \$53,000
- \$73,000

J. Formation of Partnership

2M88#33. In 1987, Dave Burr acquired a 20% interest in a partnership by contributing a parcel of land. At the time of Burr's contribution, the land had a fair market value of \$35,000, an adjusted basis to Burr of \$8,000, and was subject to a mortgage of \$12,000. Payment of the mortgage was assumed by the partnership. Burr's basis for his interest in the partnership is

- \$0
- \$ 5,600
- \$ 8,000
- \$23,000

2M88#35. On December 31, 1987, Gail Raff received a 10% interest in the capital of Cole & Co., a partnership, for past services rendered. Cole's net assets at December 31 had a basis of \$70,000 and a fair market value of \$100,000. How much ordinary income should Gail include in her 1987 return for the partnership interest transferred to her by the other partners?

- \$0
- \$ 3,000
- \$ 7,000
- \$10,000

2M87#53. Ben Krug, sole proprietor of Krug Dairy, hired Jan Karl in 1980 for an agreed salary and the promise of a 10% partnership capital interest if Karl

Accounting Practice

continued in Krug's employ until the end of 1986. On January 1, 1987, when the fair value of the business was \$300,000, the partnership was formed as agreed. On what amount will Karl have to pay tax in 1987 for the partnership capital interest received by him?

- a. \$0
- b. \$12,000
- c. \$18,000
- d. \$30,000

K. Basis of Partner's Interest

2N88#34. The following information pertains to land contributed by Pink for a 50% interest in a new partnership:

Adjusted basis to Pink	\$100,000
Fair market value	300,000
Mortgage assumed by partnership	30,000

The basis for Pink's partnership interest is

- a. \$ 70,000
- b. \$ 85,000
- c. \$100,000
- d. \$300,000

2N88#35. On July 1, 1987, in exchange for past services rendered, Eng received a 5% interest in the capital of State Associates, a partnership. State's net assets at July 1, 1987, had a basis of \$200,000 and a fair market value of \$300,000. What amount of ordinary income should Eng include in his 1987 return for the partnership interest transferred to him by the other partners?

- a. \$ 5,000
- b. \$ 7,500
- c. \$10,000
- d. \$15,000

2N88#36. The holding period of property acquired by a partnership as a contribution to the contributing partner's capital account

- a. Begins with the date of contribution to the partnership.
- b. Includes the period during which the property was held by the contributing partner.
- c. Is equal to the contributing partner's holding period prior to contribution to the partnership.
- d. Depends on the character of the property transferred.

2M87#54. The following information pertains to land contributed by Bea Dott for a 30% interest in a new partnership:

Dott's adjusted basis	\$42,000
Fair market value	150,000
Mortgage assumed by partnership	60,000

How much is Dott's basis for her partnership interest?

- a. \$0
- b. \$24,000
- c. \$27,000
- d. \$42,000

2N86#53. The holding period of property acquired by a partnership as a contribution to the contributing partner's capital account

- a. Includes the period during which the property was held by the contributing partner.
- b. Is subtracted from the period during which the property was held by the contributing partner.
- c. Begins with the date of contribution to the partnership.
- d. Depends on whether the transfer to the partnership results in a gain or a loss to the contributing partner.

2M85#58. The following information pertains to land contributed by Earl Mott for a 50% interest in a new partnership:

Adjusted basis to Mott	\$50,000
Fair market value	90,000
Mortgage assumed by partnership	10,000

Mott's basis for his partnership interest is

- a. \$40,000
- b. \$45,000
- c. \$55,000
- d. \$80,000

L. Determination of Partner's Taxable Income and Partner's Elections

2M88#36. Dunn and Shaw are partners who share profits and losses equally. In the computation of the partnership's 1987 book income of \$100,000, guaranteed payments to partners totaling \$60,000 and charitable contributions totaling \$1,000 were treated as expenses. What amount should be reported as ordinary income on the partnership's 1987 return?

- a. \$100,000
- b. \$101,000
- c. \$160,000
- d. \$161,000

2N85#57. A partner's taxable income, arising from the partner's interest in a partnership, includes

- a. Only the partner's share of partnership income actually distributed to the partner during the year.
- b. The partner's share of partnership income, whether or not distributed to the partner during the year.
- c. Only the partner's salary actually paid to the partner during the year.
- d. Only the partner's salary and interest paid to the partner during the year, and deducted by the partnership during that year.

Selected Questions

M. Accounting Periods of Partnership and Partners

- 2N86#52.** Without obtaining prior approval from the IRS, a newly formed partnership may adopt
- A taxable year which is the same as that of all of its principal partners.
 - A calendar year, only if it comprises a 12-month period.
 - A January 31 year-end if it is a retail enterprise, and all of its principal partners are on a calendar year.
 - Any taxable year that it deems advisable to select.

N. Partner Dealing With Own Partnership

- 2N88#37.** In the computation of the ordinary income of a partnership, a deduction is allowed for
- Contributions to qualified charities.
 - The net operating loss deduction.
 - Guaranteed payments to partners.
 - Short-term and long-term capital losses.

2N87#40. Sara Loy is a member of a four-person equal partnership. In 1987, Sara sold 100 shares of listed stock to the partnership for the stock's fair market value of \$20,000. Sara's basis for this stock, that was purchased in 1980, was \$14,000. Sara's recognized gain on the sale of this stock was

- \$0
- \$1,500
- \$4,500
- \$6,000

2M87#55. In March 1987, Lou Cole bought 100 shares of a listed stock for \$10,000. In May 1987, Cole sold this stock, for its fair market value of \$16,000, to the partnership of Rook, Cole & Clive. Cole owned a one-third interest in this partnership. In Cole's 1987 tax return, what amount should be reported as short-term capital gain as a result of this transaction?

- \$6,000
- \$4,000
- \$2,000
- \$0

2N85#56. In computing the ordinary income of a partnership, a deduction is allowed for

- Guaranteed payments to partners.
- Short-term capital losses.
- The first \$100 of dividends received from qualifying domestic corporations.
- Contributions to recognized charities.

2M85#59. Kay Shea owns an 85% interest in the capital and profits of Admor Antiques, a partnership. In 1984 Kay sold an oriental lamp to Admor for \$5,000.

Kay bought this lamp in 1970 for her personal use at a cost of \$1,000 and had used the lamp continuously in her home until the lamp was sold to Admor. Admor purchased the lamp as inventory for sale to customers in the ordinary course of business. What is Kay's reportable gain in 1984 on the sale of the lamp to Admor?

- \$4,000 ordinary income.
- \$4,000 long-term capital gain.
- \$3,400 ordinary income.
- \$3,400 long-term capital gain.

O. Treatment of Liabilities

2M85#57. Hall and Haig are equal partners in the firm of Arosa Associates. On January 1, 1984, each partner's adjusted basis in Arosa was \$40,000. During 1984 Arosa borrowed \$60,000, for which Hall and Haig are personally liable. Arosa sustained an operating loss of \$10,000 for the year ended December 31, 1984. The basis of each partner's interest in Arosa at December 31, 1984, was

- \$35,000
- \$40,000
- \$65,000
- \$70,000

P. Distribution of Partnership Assets

2N87

Items 38 and 39 are based on the following data:

Mike Reed, a partner in Post Co., received the following distribution from Post:

	<i>Post's basis</i>	<i>Fair market value</i>
Cash	\$11,000	\$11,000
Land	5,000	12,500

Before this distribution, Reed's basis in Post was \$25,000.

38. If this distribution were nonliquidating, Reed's recognized gain or loss on the distribution would be

- \$11,000 gain.
- \$ 9,000 loss.
- \$ 1,500 loss.
- \$0.

39. If this distribution were in complete liquidation of Reed's interest in Post, Reed's basis for the land would be

- \$14,000
- \$12,500
- \$ 5,000
- \$ 1,500

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2N86#54. The basis of property (other than money) distributed by a partnership to a partner, in complete liquidation of the partner's interest, shall be an amount equal to the

- a. Adjusted basis of such partner's interest in the partnership, increased by any money distributed in the same transaction.
- b. Adjusted basis of such partner's interest in the partnership, reduced by any money distributed in the same transaction.
- c. Fair market value of the property.
- d. Book value of the property.

2N85#58. In 1982, Lisa Bara acquired a one-third interest in Dee Associates, a partnership. In 1984, when Lisa's entire interest in the partnership was liquidated, Dee's assets consisted of the following: cash, \$20,000; tangible property with a basis of \$46,000 and a fair market value of \$40,000. Dee had no liabilities. Lisa's adjusted basis for her one-third interest was \$22,000. Lisa received cash of \$20,000 in liquidation of her entire interest. What was Lisa's recognized loss in 1984 on the liquidation of her interest in Dee?

- a. \$0.
- b. \$2,000 short-term capital loss.
- c. \$2,000 long-term capital loss.
- d. \$2,000 ordinary loss.

2M85#60. Ted King's adjusted basis for his partnership interest in Troy Company was \$24,000. In complete liquidation of his interest in Troy, King received cash of \$4,000 and realty having a fair market value of \$40,000. Troy's adjusted basis for this realty was \$15,000. King's basis for the realty is

- a. \$ 9,000
- b. \$15,000
- c. \$16,000
- d. \$20,000

Q. Termination of Partnership

2M88#37. On November 1, 1987, Kerry and Payne, each of whom was a 20% partner in the calendar-year partnership of Roe Co., sold their partnership interests to Reed, who was a 60% partner. For tax purposes, the Roe Co. partnership

- a. Was terminated as of November 1, 1987.
- b. Was terminated as of December 31, 1987.
- c. Continues in effect until a formal partnership dissolution notice is filed with the IRS.
- d. Continues in effect until a formal partnership dissolution resolution is filed in the office of the county clerk where Roe Co. had been doing business.

2N87#37. Dave Cole's adjusted basis for his interest in Marb Associates, a partnership, was \$50,000. This amount included \$20,000 of partnership liabilities for which Cole was personally liable. Marb had no unrealized receivables or substantially appreciated inventory. After having been paid his share of partnership

income for the tax year, Cole sold his entire interest in Marb for \$40,000 cash and a release from all partnership liabilities. Cole's recognized gain or loss on the sale of his interest in Marb was

- a. \$0.
- b. \$10,000 ordinary income.
- c. \$10,000 capital gain.
- d. \$10,000 capital loss.

2N85#59. A partnership is terminated for tax purposes

- a. Only when it has terminated under applicable local partnership law.
- b. When at least 50% of the total interest in partnership capital and profits changes hands by sales or exchange within 12 consecutive months.
- c. When the sale of partnership assets is made only to an outsider, and not to an existing partner.
- d. When the partnership return of income (Form 1065) ceases to be filed by the partnership.

2N85#60. For tax purposes, a retiring partner who receives retirement payments ceases to be regarded as a partner

- a. On the last day of the taxable year in which the partner retires.
- b. On the last day of the particular month in which the partner retires.
- c. The day on which the partner retires.
- d. Only after the partner's entire interest in the partnership is liquidated.

R. Types of Organizations

2N88#38. Carita Fund, organized and operated exclusively for charitable purposes, provides insurance coverage, at amounts substantially below cost, to exempt organizations involved in the prevention of cruelty to children. Carita's insurance activities are

- a. Exempt from tax.
- b. Treated as unrelated business income.
- c. Subject to the same tax provisions as those applicable to insurance companies.
- d. Considered "commercial-type" as defined by the Internal Revenue Code.

2M88#39. A condominium management association wishing to be treated as a homeowners association and to qualify as an exempt organization for a particular year

- a. Need **not** file a formal election.
- b. Must file an election as of the date the association was organized.
- c. Must file an election at the beginning of the association's first taxable year.
- d. Must file a separate election for each taxable year no later than the due date of the return for which the election is to apply.

Selected Questions

2N87#33. To qualify as an exempt organization, the applicant

- a. Must fall into one of the specific classes upon which exemption is conferred by the Internal Revenue Code.
- b. Can **not**, under any circumstances, be a foreign corporation.
- c. Can **not**, under any circumstances, engage in lobbying activities.
- d. Can **not** be exclusively a social club.

2M87#60. The private foundation status of an exempt organization will terminate if it

- a. Does **not** distribute all of its net assets to one or more public charities.
- b. Qualifies as an exempt operating foundation.
- c. Becomes a public charity.
- d. Is governed by a charter that limits the organization's exempt purposes.

2N86#55. Which one of the following types of organizations qualifies as an organization exempt from income tax?

- a. All "feeder" organizations, primarily conducting businesses for profit, but distributing 100% of their profits to organizations exempt from taxation.
- b. A social club, supported solely by members' dues and members' purchases of food and drink for consumption on club premises, with 100% of the club's profits used for its recreational facilities.
- c. A private foundation organized to influence legislation pertaining to protection of the environment.
- d. A business league operated primarily to publish a yearbook comprised of members' paid advertisements, solicited by paid employees.

S. Requirements for Exemption

2N88#39. Annual information returns of exempt organizations must be filed by

- a. Churches.
- b. Internally supported auxiliaries of churches.
- c. Private foundations.
- d. All exempt organizations whose gross receipts in each taxable year are less than \$5,000.

2M88#40. An organization wishing to qualify as an exempt organization

- a. Is prohibited from issuing capital stock.
- b. Is limited to three prohibited transactions a year.
- c. Must **not** have non-U.S. citizens on its governing board.
- d. Must be of a type specifically identified as one of the classes on which exemption is conferred by the Code.

2N87#32. Which one of the following statements is correct with regard to exempt organizations?

- a. An organization is automatically exempt from tax merely by meeting the statutory requirements for exemption.
- b. Exempt organizations that are required to file annual information returns must disclose the identity of all substantial contributors, in addition to the amount of contributions received.
- c. An organization will automatically forfeit its exempt status if any executive or other employee of the organization is paid compensation in excess of \$150,000 per year, even if such compensation is reasonable.
- d. Exempt status of an organization may **not** be retroactively revoked.

2M87#52. To qualify as an exempt organization, the applicant

- a. Need **not** be specifically identified as one of the classes upon which exemption is conferred by the Internal Revenue Code, provided that the organization's purposes and activities are of a nonprofit nature.
- b. Must **not** be classified as a social club.
- c. Must file a written application with the Internal Revenue Service, even where no official forms are provided.
- d. Must meet the tests that permit donors to deduct their contributions on their individual or corporate tax returns.

2N86#56. To qualify as an exempt organization,

- a. A written application need **not** be filed if no applicable official form is provided.
- b. No employee of the organization is permitted to receive compensation in excess of \$100,000 per year.
- c. The applicant must be of a type specifically identified as one of the classes upon which exemption is conferred by the Code.
- d. The organization is prohibited from issuing capital stock.

T. Unrelated Business Income

2N88#40. The filing of a return covering unrelated business income

- a. Is required of all exempt organizations having at least \$1,000 of unrelated business taxable income for the year.
- b. Relieves the organization of having to file a separate annual information return.
- c. Is **not** necessary if all of the organization's income is used exclusively for charitable purposes.
- d. Must be accompanied by a minimum payment of 50% of the tax due as shown on the return, with the balance of tax payable six months later.

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2M88#38. An exempt organization subject to tax on its 1988 unrelated business income

- a. Must comply with the Code provisions regarding installment payments of estimated income tax by corporations.
- b. Must pay at least 50% of the tax due as shown on the return when filed, with the balance of tax payable six months later.
- c. May defer payment of the tax for up to nine months following the due date of the return.
- d. May elect to make installment payments of estimated tax but is **not** required to do so.

2N87#31. If an exempt organization is a charitable trust, then unrelated business income is

- a. Not subject to tax.
- b. Taxed at rates applicable to corporations.
- c. Subject to tax even if such income is less than \$1,000.
- d. Subject to tax only for the amount of such income in excess of \$1,000.

2M87#56. If an exempt organization is a corporation, the tax on unrelated business taxable income is

- a. Computed at corporate income tax rates.

b. Computed at rates applicable to trusts.

c. Treated as a credit against the tax on recognized capital gains.

d. Abated.

2N86#57. With regard to unrelated business income of an exempt organization, which one of the following statements is true?

a. If an exempt organization has any unrelated business income, such organization automatically forfeits its exempt status for the particular year in which such income was earned.

b. When an unrelated trade or business activity results in a loss, such activity is excluded from the definition of unrelated business.

c. If an exempt organization derives income from conducting games of chance, in a locality where such activity is legal, and in a state that confines such activity to nonprofit organizations, then such income is exempt from the tax on unrelated business income.

d. Dividends and interest earned by all exempt organizations always are excluded from the definition of unrelated business income.

SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. Presentation of Financial Statements or Worksheets

- | | | |
|---|---|--|
| A. Balance Sheet
1M89# 1 d
1M89# 2 d
1M89# 3 a
1M89# 4 c | 1M89# 7 a
1M89# 9 b
1M89# 10 a or b
1M89# 16 c
1M89# 17 b | E. Consolidated Financial Statements or Worksheets
1M89# 55 c
1M89# 56 b
1M89# 57 b
1M89# 58 c
1N88# 2 a
1N88# 3 c
1N88# 4 b
1N88# 5 b
1N88# 6 a |
| B. Income Statement
1N88# 7 d
1N88# 8 c
1N88# 9 a | D. Statement of Owners' Equity
1M89# 13 c
1M89# 14 d
1M89# 18 a | 1M88# 10 b
1M88# 11 a
1M88# 13 a
1M88# 14 b
1M88# 15 c
1M88# 16 c
1M88# 17 c
2M87# 4 b
2M87# 5 c
2M87# 6 a
2M87# 7 c
2M87# 9 d |
| C. Statement of Cash Flows
1M89# 5 c
1M89# 6 a | | |

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

- | | | | |
|--|---|--|--|
| A. Cash, Marketable Securities, and Investments
1N88# 1 c
1N88# 14 b
1N88# 15 d
1M88# 1 b
1M88# 12 c
1M88# 18 c
1N87# 1 c
1N87# 2 b
1N87# 3 c
1N87# 6 c
1M87# 1 b
1M87# 3 a
1M87# 4 a
1M87# 19 b
2N86# 15 b
1M86# 1 a
1M86# 2 b
1M86# 3 c
1M86# 5 c
1N85# 2 d
1N85# 6 b
1M85# 1 c
1M85# 2 b
1M85# 3 b | B. Receivables and Accruals
1M89# 8 d
1M89# 15 c
1N88# 10 a
1N88# 16 c
1N88# 18 b
1M88# 19 d
1M88# 20 b
1N87# 4 b
1N87# 7 c
1M87# 2 c
1M87# 6 c
1M87# 12 a
2N86# 3 d
2N86# 4 c
2N86# 16 c
1M86# 6 c
1M86# 7 d
1M86# 9 c
1N85# 3 c
1M85# 5 c
1M85# 6 a
1M85# 7 a
1M85# 9 d | C. Inventories
1M89# 21 b
1M89# 22 d
1N88# 17 d
1N88# 19 b
1M88# 21 d
1M88# 22 c
1N87# 5 a
1N87# 9 a
1M87# 16 b
1M87# 17 d
2N86# 1 b
2N86# 13 c
1M86# 4 b
1M86# 12 a
1N85# 5 b
1N85# 9 c
1N85# 10 a
1M85# 8 d
1M85# 10 c | D. Property, Plant, and Equipment Owned or Leased
1M89# 23 b
1M89# 25 a
1M89# 26 c
1M89# 27 b
1M88# 23 b
1M88# 24 a
1M88# 25 c
1M87# 7 a
1M87# 8 c
1M87# 9 d
1N86# 2 a
1N86# 3 c
2N86# 2 d
2N86# 7 b
2N86# 8 d
1M86# 15 d
1M86# 16 c
1M86# 19 d
1N85# 11 a
1N85# 12 d
1N85# 13 d
1N85# 15 b
1N85# 19 b
1N85# 26 b |
|--|---|--|--|

Accounting Practice

E. Intangibles and Other Assets	1N88# 12 b	1N87# 10 d	1N86# 5 b
	1N88# 23 d	1N87# 11 b	1M86# 11 b
1M89# 28 a	1N88# 24 c	1M87# 10 c	1M86# 14 a
1M89# 29 a	1M88# 26 b	1M87# 20 b	1M86# 18 d
1N88# 11 b	1M88# 27 c	1N86# 1 d	1M85# 20 c

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

A. Payables and Accruals	2M85# 1 b	D. Capitalized Lease Liability	1M87# 27 d
	2M85# 2 d		1M87# 28 b
	2M85# 7 d		1M87# 37 b
1M89# 24 b		1M89# 44 b	1M87# 38 a
1M89# 30 c		1N88# 22 a	1N86# 15 a
1M89# 31 b		1N88# 29 c	1N86# 20 c
1M89# 32 d	B. Deferred Revenues	1M88# 35 d	1N86# 21 b
1M89# 33 b		1M88# 36 a	1N86# 22 a
1M89# 35 c	1M89# 34 b	1N87# 23 b	1M86# 31 b
1M89# 36 c	1M89# 39 c	1N87# 24 c	1M86# 37 a
1M89# 38 d	1N88# 20 d	1M87# 21 c	2M86# 8 a
1N88# 13 a	1N88# 21 b	1M87# 22 c	2M86# 17 b
1M88# 28 b	1M88# 31 a	1N86# 18 d	2M86# 20 b
1M88# 29 c	1M88# 32 c	1N86# 19 c	1N85# 21 a
1M88# 30 b	1N87# 14 c	1M86# 21 d	1N85# 24 c
1N87# 8 b	1N87# 15 c	2M86# 18 b	1N85# 31 c
1N87# 12 b	1N87# 18 d	1N85# 23 b	2M85# 4 b
1N87# 13 c	1N87# 19 d		2M85# 5 d
1N87# 17 b	1M87# 13 c	E. Bonds Payable	
1M87# 5 d	1M87# 14 b		
1M87# 11 a	1N86# 11 c	1M89# 45 d	F. Contingent Liabilities and Commitments
1M87# 15 d	1N86# 12 d	1M89# 46 a	
1N86# 4 d	1N86# 13 b	1M89# 47 c	1M89# 43 b
1N86# 6 c	1N86# 14 a	1M89# 49 b	1N88# 25 b
1N86# 7 a	2M86# 15 b	1N88# 32 a	1N88# 30 a
1N86# 8 a	1N85# 14 c	1N88# 39 d	1M88# 40 b
1N86# 9 b	1N85# 22 d	1M88# 37 c	1M88# 41 c
1N86# 10 d	2M85# 10 a	1M88# 38 d	1N87# 31 b
1M86# 22 b		1M88# 39 b	1N87# 35 c
1M86# 23 d		1N87# 25 b	1M87# 29 b
1M86# 25 c	C. Deferred Income Tax Liabilities	1N87# 26 d	1M87# 30 c
1M86# 26 e		1N87# 27 d	1N86# 23 d
2M86# 9 b	1M89# 37 c	1N87# 28 b	1N86# 24 b
1N85# 17 c	1M89# 40 d	1N87# 29 c	1M86# 29 b
1N85# 18 c	1M89# 41 d	1M87# 25 b	2M86# 7 a
1N85# 25 a	1M89# 42 a	1M87# 26 d	1N85# 20 a
			2M85# 3 b

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

A. Preferred and Common Stock	2N85# 13 c	C. Retained Earnings and Dividends	1N86# 31 b
	1M85# 14 d		1N86# 39 b
	1M85# 15 b		2N85# 14 b
1N88# 48 c		2M89# 2 a	2N85# 15 a
1M88# 42 b	B. Additional Paid-in Capital	2M89# 3 d	1M85# 17 a
1N86# 25 b		1N88# 60 d	1M85# 18 a
1N86# 26 c	1N88# 28 a	1M88# 43 b	1M85# 24 d
1N86# 28 b	1N86# 27 d	1N87# 34 d	
2N85# 12 c	1M85# 16 d	1M87# 34 c	

Unofficial Answers

D. Treasury Stock and Other Contra Accounts

2M89# 4 b
2M89# 6 c
1N88# 44 d
1N86# 32 d
2N85# 16 b

E. Stock Options, Warrants, and Rights

2M89# 7 c
1N88# 41 a
1N87# 40 d
1N86# 33 b

1N86# 35 a
2N85# 18 c
2N85# 19 c
1M85# 21 b

G. Partnerships

2M89# 5 a
2M89# 9 a
2M89# 10 a
1N88# 26 c
1N88# 27 b

1M87# 33 a
1M87# 40 a
1N86# 36 c
2N85# 10 c
2N85# 11 b
1M85# 22 b
1M85# 26 c

F. Reorganization and Change in Entity

1N88# 56 b
1M88# 44 c

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

A. Revenues and Gains

1M89# 11 a
1M89# 50 c
1M89# 51 d
1M89# 53 b
1M89# 54 b
1M89# 59 c
1N88# 31 d
1N88# 33 c
1N88# 34 d
1N88# 35 d
1N88# 36 d
1N88# 37 a
1N88# 38 a
1N88# 40 a
1N88# 42 d
1M88# 45 d
1M88# 47 c
1N87# 21 b
1N87# 30 c
1N87# 32 d
1N87# 33 a
1N87# 36 c
1N87# 37 c
1N87# 38 b
1N87# 39 a
1M87# 35 c
1M87# 36 d
1M87# 39 d
2M87# 1 a
2M87# 2 b
2M87# 3 c
2M87# 13 d
2M87# 14 b
2M87# 15 c
2M87# 16 d
2M87# 17 c
2M87# 19 d
2M87# 20 a
1N86# 29 c
1N86# 30 a
1N86# 34 a
1N86# 37 b
1N86# 38 c
1N86# 40 c
1N86# 42 a

1N86# 43 b
1M86# 27 c
1M86# 30 a
1M86# 32 a
1M86# 33 d
1M86# 34 b
1M86# 35 b
1M86# 36 d
1M86# 38 d
1M86# 39 a
1M86# 40 c
1M86# 53 b
1N85# 27 a
1N85# 28 d
1N85# 29 b
1N85# 30 a
1N85# 32 b
1N85# 33 d
1N85# 35 a
1N85# 36 d
1N85# 39 b
1M85# 23 b
1M85# 27 d
1M85# 30 d
1M85# 31 b
1M85# 32 b
1M85# 33 b
1M85# 34 a
1M85# 39 b
1M85# 50 c

B. Expenses and Losses

1M89# 12 a
1M89# 19 b
1M89# 20 c
1M89# 48 c
1N88# 43 b
1M88# 48 a
1M88# 49 b
1M88# 51 d
1M88# 52 c
1N87# 42 a
1N87# 43 a
1N87# 44 d
1N87# 45 a
1N87# 46 d

1N87# 47 d
1M87# 31 a
1M87# 32 b
1M87# 41 a
1M87# 42 c
1M87# 43 c
1M87# 44 b
1M87# 45 c
1M87# 48 d
1M87# 52 d
1N86# 41 b
1N86# 44 d
1N86# 45 c
1N86# 46 c
1N86# 47 c
1N86# 48 d
1N86# 49 d
1N86# 50 d
2N86# 6 d
2N86# 14 c
1M86# 42 d
1M86# 43 b
1M86# 44 b
1M86# 45 d
1M86# 46 c
1M86# 47 a
1M86# 48 d
1M86# 54 a
1M86# 55 a
1M86# 56 d
1M86# 60 c
1N85# 37 c
1N85# 38 b
1N85# 40 c
1N85# 42 a
1N85# 43 b
1N85# 44 d
1N85# 46 c
1M85# 35 a
1M85# 36 d
1M85# 38 c
1M85# 41 c
1M85# 43 b
1M85# 44 a
1M85# 45 b

D. Recurring Versus Nonrecurring Transactions and Events

1M89# 60 d
1N88# 45 d
1N88# 47 b
1N87# 41 c
1M87# 49 b
1M87# 51 a
1M87# 59 d
2N86# 9 a
2N86# 10 b
1M86# 41 b
1M86# 59 a
1N85# 48 a
1M85# 46 d
1M85# 48 d

E. Accounting Changes

1M89# 52 a
1N87# 51 b
1M87# 47 c
2N86# 11 a
2N86# 12 c
1M86# 57 a
1M86# 58 c
1N85# 49 b
1N85# 50 d
1M85# 28 c
1M85# 49 c

F. Earnings Per Share

1N88# 50 a
1N88# 57 d
1N87# 48 c
1N87# 52 b
1M87# 58 b
2M87# 8 d
2N86# 17 b
2N86# 18 a
1M86# 51 c
1M86# 52 b
1N85# 54 c
1N85# 55 d
1M85# 51 b

Accounting Practice

VI. Other Financial Topics

- | | | | |
|--|--|--|--|
| A. Disclosures in Notes to the Financial Statements
2M89# 16 c
1N88# 51 c
1M88# 46 d | E. Historical Cost, Constant Dollar Accounting, and Current Cost
2M89# 13 b
1N88# 52 a
1M88# 55 d
1N87# 54 d
1N87# 55 a
1M87# 57 b
1N86# 60 c
2M86# 1 b
2M86# 10 d
1N85# 51 c
1M85# 54 c | 1N85# 59 b
1M85# 55 d | 2M86# 6 c
1N85# 60 a
1M85# 59 c |
| C. Nonmonetary Transactions
1M88# 50 b
2M87# 18 b
1N86# 52 b
1N86# 53 b
2M86# 11 d
1N85# 41 d
1M85# 52 a | F. Gain Contingencies
1N88# 53 a
1M88# 56 d
1N86# 51 a
1N85# 52 a
1M85# 58 a | H. Employee Benefits
2M89# 18 c
2M89# 19 b
1N88# 54 c
1N87# 56 c
1N87# 57 d
1M87# 50 a
1N85# 53 c | J. Development Stage Enterprises
1N88# 55 d
1M88# 58 a
1M88# 59 c |
| D. Interim Financial Statements
2M89# 12 c
1N88# 46 a
1M88# 54 b
1N87# 53 a
2M87# 12 a
1N86# 54 a
2M86# 12 a
1N85# 45 a
1M85# 47 a
1M85# 53 a | G. Segments and Lines of Business
1N87# 59 b
1M87# 56 d
1N86# 55 c
2M86# 2 c | I. Analysis of Financial Statements
2M89# 14 b
2M89# 15 d
1N88# 49 d
1M88# 57 a
1N87# 58 b
1N87# 60 c
1M87# 54 d
1M87# 55 a
2M87# 10 c
1N86# 56 d
1N86# 57 c
1N86# 59 c
2M86# 4 c
2M86# 5 c | K. Personal Financial Statements
2M89# 17 d
1N88# 59 b
1M88# 60 a
1M87# 53 a
1N86# 58 b
2M86# 3 a
1N85# 57 d
1N85# 58 a
1M85# 60 c |
| | | | L. Combined Financial Statements
1N88# 58 d
1M88# 53 b
1M87# 60 c
2M86# 13 d |

VII. Cost Accumulation, Planning, and Control

- | | | | |
|---|---|---|--|
| A. Nature of Cost Elements
2M87# 23 a
2M87# 24 c
2M87# 25 a
2N86# 29 c
2N85# 1 c
2N85# 2 a
2N85# 3 b | C. Standard Costing
2M87# 32 c
2M86# 23 b
2M86# 24 a | E. Absorption and Variable Costing
2M87# 29 b
2M86# 26 a | H. Capital Budgeting Techniques
2M87# 37 b
2M87# 38 b
2N86# 31 a
2N86# 32 d
2N86# 33 b
2N85# 7 a
2N85# 8 a
2M85# 13 c |
| B. Process and Job Order Costing
2M87# 40 a
2N86# 27 a
2N86# 38 c
2M86# 22 b
2M86# 25 d
2M86# 28 a
2M85# 12 d
2M85# 15 b | D. Joint and By-Product Costing, Spoilage, Waste, and Scrap
2M87# 31 c
2N86# 30 b
2N86# 37 b
2N86# 39 d
2M86# 21 b
2M86# 36 d
2M86# 39 b
2N85# 4 c
2N85# 5 a
2N85# 6 c | F. Budgeting and Flexible Budgeting
2M87# 39 c
2N86# 26 c | I. Performance Analysis
2M87# 35 d
2M87# 36 a
2N86# 22 b
2N86# 23 d
2N86# 25 c
2M86# 37 c
2M86# 38 d |
| | | G. Breakeven and Cost-Volume-Profit Analysis
2M87# 34 b
2N86# 24 a
2N86# 34 b
2M86# 27 c
2M86# 29 c
2M86# 30 d | |

Unofficial Answers

2M85# 18 b	2M87# 27 a	2N86# 35 b	2N85# 9 d
2M85# 19 c	2M87# 28 b	2N86# 36 a	2N85# 20 a
	2M87# 30 d	2N86# 40 d	2M85# 11 d
J. Other	2M87# 33 d	2M86# 31 d	2M85# 14 c
	2N86# 21 d	2M86# 32 b	2M85# 17 c
2M87# 22 b	2N86# 28 c	2M86# 40 c	2M85# 20 b
2M87# 26 c			

VIII. Not-for-Profit and Governmental Accounting

A. Fund Accounting	2N88# 42 c	D. Various Types of Not-for-Profit and Governmental Organizations	2M88# 52 a
2M89# 21 c	2N88# 43 d		2M88# 53 c
2M89# 22 a	2N88# 44 c		2M88# 54 a
2M89# 23 c	2N88# 45 b		2M88# 55 c
2M89# 24 c	2N88# 46 d	2M89# 29 a	2M88# 56 c
2M89# 25 d	2N88# 47 c	2M89# 30 d	2M88# 57 d
2M89# 26 b	2N88# 48 c	2M89# 31 d	2M88# 58 b
2M88# 44 b	2N88# 49 c	2M89# 32 c	2M88# 59 c
2M88# 45 a	2N88# 51 b	2M89# 33 c	2M88# 60 a
2M88# 46 d	2N88# 52 c	2M89# 36 b	2N87# 41 a
2M88# 47 c	2M88# 41 d	2M89# 37 d	2N87# 42 d
2M88# 48 b	2M88# 42 a	2M89# 38 b	2N87# 43 b
2M88# 49 c	2M88# 43 c	2N88# 53 b	2N87# 44 b
2M88# 50 d	2N87# 47 c	2N88# 54 a	2N87# 45 b
	2N87# 48 a	2N88# 56 d	2N87# 46 b
	2N87# 52 c	2N88# 57 d	2N87# 49 c
B. Types of Funds and Fund Accounts	2N87# 53 d	2N88# 58 b	2N87# 50 b
	2N87# 54 d	2N88# 59 a	2N87# 51 c
2M89# 28 a	2N87# 55 a	2N88# 60 a	2N87# 57 a
2M89# 39 b	2N87# 56 a	2M88# 51 d	2N87# 59 d
2N88# 41 a	2N87# 58 b		2N87# 60 c

IX. Federal Taxation — Individuals, Estates, and Trusts

A. Inclusions for Gross Income and Adjusted Gross Income	2N87# 2 a	2M85# 24 a	C. Gain or Loss on Property Transactions
2M89# 44 a	2N87# 3 c	2M85# 28 d	
2M89# 45 c	2N87# 4 d	2M85# 29 c	2M89# 41 b
2M89# 54 a	2N87# 6 d	2M85# 31 b	2M89# 42 a
2N88# 1 c	2N87# 7 a	2M85# 32 c	2M89# 52 b
2N88# 2 d	2N87# 8 c	2M85# 37 c	2N87# 18 b
2N88# 3 b	2N87# 9 b		2N87# 19 a
2N88# 5 d	2N87# 10 a	B. Exclusions and Adjustments to Arrive at Adjusted Gross Income	2N87# 20 a
2N88# 6 a	2M86# 41 a		2M86# 44 a
2N88# 7 c	2M86# 42 b	2M89# 46 c	2M86# 54 b
2N88# 8 b	2M86# 45 b	2N88# 10 d	2M86# 55 a
2N88# 9 d	2M86# 49 d	2N88# 11 a	2M86# 58 d
2M88# 1 a	2M86# 52 a	2M88# 15 c	2M85# 38 d
2M88# 2 d	2N85# 24 d	2M88# 16 c	2M85# 40 a
2M88# 3 d	2N85# 25 a	2N87# 5 d	
2M88# 4 b	2N85# 26 b	2M86# 51 a	D. Deductions From Adjusted Gross Income
2M88# 5 a	2N85# 27 a	2N85# 21 a	
2M88# 6 d	2N85# 28 d	2N85# 22 d	2M89# 48 d
2M88# 9 a	2N85# 31 b	2M85# 22 b	2M89# 49 b
2N87# 1 b	2N85# 33 d	2M85# 26 d	
	2M85# 21 b		
	2M85# 23 a		

Accounting Practice

2M89# 50 b	2M85# 34 d	2M88# 8 d	2M89# 59 a
2M89# 51 b	2M85# 35 b	2M88# 10 b	2M89# 60 d
2N88# 13 a		2M86# 43 d	2N88# 17 c
2N88# 14 b	E. Filing Status and Exemptions	2N85# 30 d	2N88# 18 c
2N88# 15 b		2M85# 36 a	2N88# 19 d
2M88# 7 b	2M89# 43 a		2N88# 20 b
2M88# 12 d	2N88# 16 c	G. Statute of Limitations	2M88# 17 c
2M88# 13 c	2M88# 11 a		2M88# 18 b
2M88# 14 a	2N87# 17 b	2M89# 56 d	2M88# 19 b
2M86# 53 c	2M86# 46 d	2N87# 15 d	2M88# 20 c
2M86# 56 d	2M86# 59 c	2N87# 16 c	2N87# 11 c
2M86# 57 b	2N85# 40 b	2N85# 23 c	2N87# 12 b
2M86# 60 c	2M85# 25 c		2N87# 13 c
2N85# 34 d	2M85# 30 c	H. Estate and Gift Taxation and Income Taxation of Estates and Trusts	2N87# 14 d
2N85# 35 a			2M86# 47 a
2N85# 36 d	F. Tax Computations and Credits		2M86# 48 c
2N85# 37 c			2N85# 29 c
2N85# 38 c	2M89# 47 a	2M89# 57 d	2N85# 32 a
2N85# 39 a	2M89# 53 c	2M89# 58 a	2M85# 27 a
			2M85# 39 c

X. Federal Taxation—Corporations, Partnerships, and Exempt Organizations

A. Determination of Taxable Income or Loss	2N86# 60 b	2N85# 42 b	2N87# 36 a
	2N85# 44 b	2N85# 43 c	2M87# 58 c
	2N85# 45 c	2M85# 55 d	2N86# 45 a
2N88# 22 a	2N85# 46 d		2M85# 54 d
2N88# 23 c	2N85# 47 a	D. Personal Holding Companies	
2N88# 24 b	2N85# 48 b		I. Liquidations and Dissolutions
2N88# 28 d	2N85# 49 c	2N88# 29 b	
2M88# 22 d	2N85# 50 a	2M88# 31 c	2N88# 33 d
2M88# 23 a	2M85# 45 b	2N87# 34 c	2M87# 59 a
2M88# 24 b	2M85# 46 a	2M87# 44 d	2N85# 54 d
2M88# 25 c	2M85# 47 d	2N86# 46 d	2M85# 42 a
2M88# 26 b	2M85# 48 a	2M85# 44 c	
2M88# 27 d	2M85# 49 d		J. Formation of Partnership
2M88# 28 c	2M85# 50 a	E. Accumulated Earnings Tax	
2N87# 21 d	2M85# 51 b		2M88# 33 a
2N87# 22 c	2M85# 52 c	2N87# 35 d	2M88# 35 d
2N87# 23 b		2M87# 41 a	2M87# 53 d
2N87# 24 d	B. Tax Computations and Credits	2N86# 47 a	
2N87# 25 a		2N85# 52 c	K. Basis of Partner's Interest
2N87# 26 a	2M88# 29 a	2M85# 43 b	
2N87# 28 c	2N87# 30 c		2N88# 34 b
2N87# 29 d	2M87# 51 c	F. Distributions	2N88# 35 d
2M87# 42 d	2N86# 43 d		2N88# 36 b
2M87# 46 b	2N85# 51 a	2N88# 31 c	2M87# 54 a
2M87# 47 b	2N85# 55 d	2M87# 57 b	2N86# 53 a
2M87# 48 d		2M85# 53 c	2M85# 58 b
2M87# 49 d	C. S Corporations		
2M87# 50 a		G. Tax-Free Incorporation	L. Determination of Partner's Taxable Income and Partner's Elections
2N86# 41 a	2N88# 25 d		
2N86# 42 d	2M88# 30 c	2M88# 34 c	2M88# 36 b
2N86# 44 b	2N87# 27 c	2M87# 45 a	2N85# 57 b
2N86# 48 b	2M87# 43 b	H. Reorganizations	
2N86# 49 c	2N86# 50 d		
2N86# 51 c	2N86# 58 a	2N88# 32 a	
2N86# 59 d	2N85# 41 d	2M88# 32 b	

Unofficial Answers

M. Accounting Periods of Partnership and Partners	O. Treatment of Liabilities	Q. Termination of Partnership	S. Requirements for Exemption
2N86# 52 a	2M85# 57 c	2M88# 37 a	2N88# 39 c
		2N87# 37 c	2M88# 40 d
		2N85# 59 b	2N87# 32 b
		2N85# 60 d	2M87# 52 c
			2N86# 56 c
N. Partner Dealing With Own Partnership	P. Distribution of Partnership Assets	R. Types of Organizations	T. Unrelated Business Income
2N88# 37 c	2N87# 38 d	2N88# 38 a	2N88# 40 a
2N87# 40 d	2N87# 39 a	2M88# 39 d	2M88# 38 a
2M87# 55 a	2N86# 54 b	2N87# 33 a	2N87# 31 d
2N85# 56 a	2N85# 58 c	2M87# 60 c	2M87# 56 a
2M85# 59 a	2M85# 60 d	2N86# 55 b	2N86# 57 c

PROBLEMS — SELECTED QUESTIONS

I. Presentation of Financial Statements or Worksheets

A. Balance Sheet

1M87

Number 5 (Estimated time — — 40 to 50 minutes)

Presented below is information pertaining to Cox Stationery Supply, a calendar-year sole proprietorship owned by John Cox. The business maintains its books on the cash basis except that, at year end, the closing inventory and depreciation are recorded. On December 31, 1986, after recording inventory and depreciation, and closing the nominal accounts, Cox had the following general ledger trial balance:

<i>Cox Stationery Supply</i>		
TRIAL BALANCE		
<i>December 31, 1986</i>		
	<i>Dr.</i>	<i>Cr.</i>
Cash	\$ 16,500	
Merchandise inventory	39,000	
Equipment	52,500	
Accumulated depreciation		\$ 20,500
Note payable, bank		10,000
Payroll taxes withheld		1,300
Cox, capital		76,200
	<u>\$108,000</u>	<u>\$108,000</u>

During the last quarter of 1986, John Cox and Mary Rice, an outside investor, agreed to incorporate the business under the name of Cox Stationers, Inc. Cox will receive 1,000 shares for his business, and Rice will pay \$86,000 cash for her 1,000 shares. On January 1, 1987, they received the certificate of incorporation for Cox Stationers, Inc., and the corporation issued 1,000 shares of common stock each to Cox and Rice for the above consideration. The agreement between Cox and Rice requires that the December 31, 1986 balance sheet of the proprietorship should be converted to the accrual basis, with all assets and liabilities stated at current fair values, including Cox's goodwill implicit in the terms of the common stock issuance.

Additional information:

1. Amounts due from customers totaled \$23,500 at December 31, 1986. A review of collectibility disclosed that an allowance for doubtful accounts of \$3,300 is required.
2. The \$39,000 merchandise inventory is based on a physical count of goods priced at cost. Unsalable damaged goods costing \$2,500 are included in the count. The current fair value of the total merchandise inventory is \$45,000.
3. On July 1, 1986, Cox paid \$3,800 to renew the comprehensive insurance coverage for one year.
4. The \$10,000 note payable is dated July 1, 1986, bears interest at 12%, and is due July 1, 1987.
5. Unpaid vendors' invoices totaled \$30,500 at December 31, 1986.
6. During January 1987, final payroll tax returns filed for Cox Stationery Supply required remittances totaling \$2,100.

1M87

Number 5 (cont.)

7. Not included in the trial balance is the \$3,500 principal balance at December 31, 1986, of the three-year loan to purchase a delivery van on December 31, 1984. The debt was assumed by the corporation on January 1, 1987. The current fair value of the used equipment is \$40,000, including the delivery van.

8. Cox Stationers, Inc., has 7,500 authorized shares of \$50 par common stock.

Required:

- a. Prepare a schedule to compute Cox's goodwill implicit in the issuance to him of 1,000 shares of common stock for his business.
- b. Prepare a formal balance sheet of Cox Stationers, Inc., at January 1, 1987, immediately after the issuance of common stock to Cox and Rice. Journal entries and trial balance worksheet are **not** required.

1M86

Number 5 (Estimated time — — 40 to 50 minutes)

Rand, Inc., a nonpublic enterprise, is negotiating a loan for expansion purposes and the bank requires audited financial statements. Before closing the accounting records for the year ended December 31, 1985, Rand's controller prepared the following comparative financial statements for 1985 and 1984:

Rand, Inc.
BALANCE SHEETS
December 31, 1985 and 1984

	<u>1985</u>	<u>1984</u>
<u>Assets</u>		
Cash	\$ 275,000	\$150,000
Marketable securities, at cost	78,000	78,000
Accounts receivable	487,000	392,000
Allowance for doubtful accounts	(50,000)	(32,000)
Inventories	425,000	307,000
Property and equipment	310,000	217,000
Accumulated depreciation	(150,000)	(121,000)
Total assets	<u>\$1,375,000</u>	<u>\$991,000</u>
<u>Liabilities & Stockholders' Equity</u>		
Accounts payable & accrued liabilities	\$ 420,000	\$347,000
Estimated liability from lawsuit	100,000	—
Common stock, \$10 par	260,000	260,000
Additional paid-in capital	130,000	130,000
Retained earnings	465,000	254,000
Total liabilities & stockholders' equity	<u>\$1,375,000</u>	<u>\$991,000</u>

Rand, Inc.
INCOME STATEMENTS
For the Years Ended December 31, 1985 and 1984

	<u>1985</u>	<u>1984</u>
Net sales	\$1,580,000	\$1,250,000
Operating expenses:		
Cost of sales	755,000	690,000
Selling & administrative	485,000	365,000
Depreciation	29,000	18,000
Estimated loss from lawsuit	100,000	—
	<u>1,369,000</u>	<u>1,073,000</u>
Net income	<u>\$ 211,000</u>	<u>\$ 177,000</u>

Selected Questions

Candidate's No. _____
 State _____
 Question No. 5 Page _____

Rand, Inc.
**WORKSHEET FOR BALANCE SHEET
 AND INCOME STATEMENT**
December 31, 1985

	Balance per books	Adjustments		Corrected Balance
		Debit	Credit	
<i>Balance Sheet</i>				
Assets:	<i>Dr. (Cr.)</i>			
Cash	\$ 275,000			
Marketable securities, at cost	78,000			
Accounts receivable	487,000			
Allowance for doubtful accounts	(50,000)			
Inventories	425,000			
Property and equipment	310,000			
Accumulated depreciation	(150,000)			
	\$ 1,375,000			
Liabilities & Stockholders' Equity:	<i>Cr.</i>			
Accounts payable & accrued liabilities	\$ 420,000			
Estimated liability from lawsuit	100,000			
Common stock	260,000			
Additional paid-in capital	130,000			
Retained earnings				
Balance, 1/1/85	254,000			
Net income for 1985	211,000			
	\$ 1,375,000			
<i>Income Statement</i>				
	<i>Dr. (Cr.)</i>			
Net sales	\$(1,580,000)			
Cost of sales	755,000			
Selling & administrative expenses	485,000			
Depreciation expense	29,000			
Estimated loss from lawsuit	100,000			
Net income	\$ (211,000)			

Accounting Practice

1M86

Number 5 (cont.)

During the course of the audit, the following additional information was obtained:

1. The investment portfolio consists of short-term investments with a total market valuation of \$81,000 at December 31, 1984, and \$67,000 at December 31, 1985.
2. In discussion with company officials, it was determined that the doubtful accounts expense rate based on net sales should be reduced to 2% from 3% effective January 1, 1985.
3. As a result of errors in physical count, inventories were overstated by \$12,000 at December 31, 1984, and by \$17,500 at December 31, 1985.
4. On January 1, 1984, the cost of equipment purchased for \$30,000 was debited to repairs and maintenance. Rand depreciates machines of this type by the straight-line method over a five-year life, with no residual value.
5. On July 1, 1985, fully depreciated equipment purchased for \$21,000, was sold as scrap for \$2,500. The only entry Rand made was to debit cash and credit property and equipment for the scrap proceeds. The property and equipment (net) had a current cost of \$250,000 at December 31, 1985.
6. Advertising and promotion expense for the year ended December 31, 1984, includes the \$25,000 cost of printing sales catalogs for a special promotional campaign in January 1985.
7. Rand was named as a defendant in a lawsuit in October 1985. Rand's counsel is of the opinion that Rand has a good defense and does not anticipate any impairment of Rand's assets or that any significant liability will be incurred. Nevertheless, Rand's management wished to be conservative and established a loss contingency of \$100,000 at December 31, 1985.

Required (Ignore income taxes):

Complete the tear-out worksheet to prepare a corrected balance sheet of Rand, Inc., as of December 31, 1985, and a corrected income statement for the year ended December 31, 1985. Formal statements and journal entries are not required. The worksheet adjustments should be numbered to correspond with the numbers in the additional information. Include the completed tear-out worksheet in the proper sequence with other answer sheets.

Selected Questions

B. Income Statement

In November 1987 the FASB issued *Statement of Financial Accounting Standards No. 96*, "Accounting for Income Taxes." Income tax calculations in this section of *Selected Questions & Unofficial Answers* are based on *APB Opinion No. 11*, "Accounting for Income Taxes," for all examination questions prior to May 1989. All subsequent examination questions and unofficial answers relating to accounting for income taxes are and will be based on SFAS No. 96.

1M89

Number 4 (Estimated time — — 45 to 55 minutes)

Before closing the books for the year ended December 31, 1988, Pitt Corp. prepared the following condensed trial balance:

Condensed Trial Balance December 31, 1988

	<u>Debit</u>	<u>Credit</u>
Total assets	\$ 7,082,500	
Total liabilities		\$ 1,700,000
Common stock		1,250,000
Additional paid-in capital		2,097,500
Donated capital		90,000
Retained earnings, 1/1/88		1,650,000
Net sales		6,250,000
Cost of sales	3,750,000	
Selling and administrative expenses	1,212,500	
Interest expense	122,500	
Gain on sale of long-term investments		130,000
Income tax expense	300,000	
Loss on disposition of plant assets	225,000	
Loss due to earthquake damage	475,000	
	<u>\$13,167,500</u>	<u>\$13,167,500</u>

Other financial data for the year ended December 31, 1988:

Federal income tax

Estimated tax payments	\$200,000
Accrued	<u>100,000</u>
Total charged to income tax expense (Does not properly reflect current or deferred income tax expense or intraperiod income tax allocation for income statement purposes.)	<u>\$300,000</u>

Pitt elected to apply the provisions of FASB Statement No. 96, *Accounting for Income Taxes*, in its financial statements for the year ended December 31, 1988. The enacted tax rate on all types of taxable income for the current and future years is 30%. The alternative minimum tax is less than the regular income tax.

Temporary difference

Excess of book basis over tax basis in depreciable assets (arising from equipment donated as a capital contribution on December 31, 1988 and expected to be depreciated over five years beginning in 1989). There were no temporary differences prior to 1988.

\$90,000

1M89

Number 4 (cont.)

Non-deductible expenditure

Officers' life insurance expense

\$70,000

Earthquake damage

This damage is considered unusual and infrequent.

Capital structure

Common stock, par value \$5 per share, traded on a national exchange:

Number of shares:

Outstanding at 1/1/88	200,000
Issued on 3/30/88 as a 10% stock dividend	20,000
Sold for \$25 per share on 6/30/88	30,000
Outstanding at 12/31/88	<u>250,000</u>

Required:

- a. Using the multiple-step format, prepare a formal income statement for Pitt for the year ended December 31, 1988.
- b. Prepare a schedule to reconcile net income to taxable income reportable on Pitt's tax return for 1988.

Selected Questions

2M88

Number 4 (Estimated time — 45 to 55 minutes)

The following information pertains to Arlon Corporation:

TRIAL BALANCE December 31, 1987

	Debit	Credit
Cash	\$ 25,000	
Accounts receivable, net	75,000	
Inventory	125,000	
Property, plant, and equipment	755,000	
Accumulated depreciation		\$239,000
Accounts payable		70,000
Income tax payable		6,000
Rental revenue received in advance		5,000
Notes payable		55,000
Common stock, \$.05 par		50,000
Additional paid-in capital		305,000
Retained earnings, 1/1/87		150,000
Sales — regular		500,000
Sales — Mem Division		100,000
Proceeds from term life insurance policy		10,000
Cost of sales — regular	310,000	
Cost of sales — Mem Division	45,000	
Administrative expenses — regular	103,000	
Administrative expenses — Mem Division	15,000	
Interest expense — regular	10,500	
Interest expense — Mem Division	7,000	
Loss on disposal of Mem Division	12,500	
Gain on acquisition of bonds payable		13,000
Income tax expense	20,000	
Totals	\$1,503,000	\$1,503,000

Other Information

Income tax

Paid with Federal Tax Deposit Forms	\$14,000
Accrued	6,000
Total charged to income tax expense	<u>\$20,000*</u>

*Does not reflect current or deferred income tax expense or intraperiod income tax allocation for income statement purposes.

Income per income tax return	<u>\$99,000</u>
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Tax rate on all types of taxable income	<u>22%</u>
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Timing differences

Depreciation per financial statements — regular	\$30,000	
Depreciation per income tax return	<u>46,000</u>	\$16,000
Rental revenue received in advance		5,000

Permanent difference

Proceeds from term life insurance policy	10,000
--	--------

Discontinued operations

On June 30, 1987, Arlon sold its Mem Division for \$200,000. The carrying amount of this business segment was \$212,500 at that date. This sale was considered as a disposal of a segment of a business for financial statement purposes. Since there was no phaseout period, the measurement date was June 30, 1987.

Liabilities

On June 30, 1987, Arlon acquired \$100,000 carrying amount of its long-term bonds for \$87,000. All other liabilities mature in 1988.

Capital structure

Common stock, \$.05 par, traded over-the-counter; 1,000,000 shares issued and outstanding at 1/1/87 and 12/31/87.

Required:

Using the multiple-step format, prepare a formal income statement for Arlon for the year ended December 31, 1987, together with supporting computations of current and deferred income taxes and of income from discontinued operations.

Accounting Practice

1N86

Number 5 (Estimated time — — 40 to 50 minutes)

The following trial balance of Garr Corporation at December 31, 1985, has been adjusted except for income tax expense.

Garr Corporation TRIAL BALANCE December 31, 1985

	<u>Dr.</u>	<u>Cr.</u>
Cash	\$ 675,000	
Accounts receivable (net)	1,695,000	
Inventory	2,185,000	
Property, plant and equipment (net)	8,660,000	
Accounts payable and accrued liabilities		\$ 1,895,000
Income tax payable		360,000
Deferred income tax		285,000
Common stock		2,300,000
Additional paid-in capital		3,675,000
Retained earnings, 1/1/85		3,350,000
Net sales — Regular		10,750,000
— Plastics Division		2,200,000
Cost of sales — Regular	5,920,000	
— Plastics Division	1,650,000	
Selling and administrative expenses — Regular	2,600,000	
— Plastics Division	660,000	
Interest income — Regular		65,000
Gain on litigation settlement — Regular		200,000
Depreciation adjustment from accounting change — Regular	350,000	
Gain on disposal of Plastics Division		150,000
Income tax expense	835,000	
	<u>\$25,230,000</u>	<u>\$25,230,000</u>

Other financial data for the year ended December 31, 1985:

Income tax expense

Estimated tax payments	\$475,000
Accrued	360,000
Total charged to income tax expense (estimated)	<u>\$835,000</u>

Tax rate on all types of income 40%

Gain from litigation settlement is a taxable gain and is not considered infrequent.

The \$835,000 does not properly reflect current or deferred income tax expense or intraperiod income tax allocation for financial statement purposes.

Timing difference (not related to Plastics Division)

Depreciation per tax return	\$750,000
Depreciation per financial statements (excluding cumulative effect of accounting change)	575,000

Selected Questions

Discontinued operations

On October 31, 1985, Garr sold its Plastics Division for \$2,950,000 when the carrying amount was \$2,800,000. For financial statement reporting, this sale was considered a disposal of a segment of a business. Since there was no phase-out period, the measurement date was October 31, 1985.

Change in depreciation method

On January 1, 1985, Garr changed to the 150% declining balance method from the straight-line method of depreciation for certain of its plant assets. The pretax cumulative effect of this accounting change was determined to be a charge of \$350,000. There was no change in depreciation method for income tax purposes.

Capital structure

Common stock, \$10 par, traded on a national exchange:

	<u>Shares</u>
Outstanding at 1/1/85	200,000
Issued on 7/1/85 as a 15% stock dividend	30,000
	<u>230,000</u>

Required:

Using the multiple-step format, prepare a formal income statement for Garr for the year ended December 31, 1985. All components of income tax expense should be appropriately shown.

1M85

Number 5 (Estimated time — 40 to 50 minutes)

Before closing the books for the year ended December 31, 1984, Glenn Corporation, a Kansas corporation, prepared the following adjusted trial balance:

Adjusted Trial Balance December 31, 1984

	<u>Dr.</u>	<u>Cr.</u>
Cash	\$ 550,000	
Accounts receivable, net	1,650,000	
Inventory	2,750,000	
Property, plant and equipment	13,550,000	
Accumulated depreciation		\$ 4,400,000
Cash surrender value on officers' life insurance	65,000	
Accounts payable and accrued expenses		1,550,000
Income tax payable		200,000
Deferred income tax		150,000
Notes payable		1,500,000
Common stock		2,500,000
Additional paid-in capital		4,375,000
Retained earnings, 1/1/84		3,300,000
Net sales		12,500,000
Cost of sales	7,500,000	
Selling and administrative expenses	2,425,000	
Interest expense	245,000	
Gain on sale of long-term investments		260,000
Income tax expense	600,000	
Loss on litigation settlement	450,000	
Loss due to earthquake damage	950,000	
	<u>\$30,735,000</u>	<u>\$30,735,000</u>

Accounting Practice

1M85

Number 5 (cont.)

Other financial data for the year ended December 31, 1984:

Federal income tax

Estimated tax payments	\$400,000
Accrued	<u>\$200,000</u>
Total charged to income tax expense (estimated)	<u>\$600,000*</u>

Tax rate on all types of taxable income	<u>40%</u>
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*Does not properly reflect current or deferred income tax expense or intraperiod income tax allocation for income statement purposes.

Timing difference

Depreciation per tax return	\$760,000
Depreciation per books	580,000

Permanent difference

Premiums on officers' life insurance	\$140,000
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Capital structure

Common stock, par value \$10 per share, traded on a national exchange:

	<u>Shares</u>
Number of shares outstanding at 1/1/84	200,000
Number of shares issued on 3/30/84 as a 10% stock dividend	20,000
Number of shares sold for \$25 per share on 6/30/84	<u>30,000</u>
Number of shares outstanding at 12/31/84	<u>250,000</u>

Required:

- a. Using the multiple-step format, prepare a formal income statement for Glenn for the year ended December 31, 1984. All components of income tax expense should be appropriately shown.
- b. Prepare a schedule to reconcile net income to taxable income reportable on Glenn's tax return for 1984.

C. Statement of Cash Flows

In November 1987, the FASB issued *Statement of Financial Accounting Standards No. 95*, "Statement of Cash Flows." Accordingly, all previous examination questions and unofficial answers pertaining to "Statement of Changes in Financial Position," covered by *APB Opinion No. 19, Reporting Changes in Financial Position*, have been deleted.

Selected Questions

E. Consolidated Financial Statements or Worksheets

1N88

Number 5 (Estimated time — 40 to 50 minutes)

Peel, Inc., acquired all of the outstanding \$25 par value common stock of Stagg, Inc., on June 30, 1987, in exchange for 40,000 shares of its \$25 par value common stock. The business combination meets all conditions for a pooling of interests. On June 30, 1987, Peel's common stock closed at \$65 per share on a national stock exchange. Both corporations continued to operate as separate businesses maintaining separate accounting records with years ending December 31.

On December 31, 1987, after year-end adjustments and closing nominal accounts, the companies had condensed balance sheet accounts as follows:

	<u>Peel</u>	<u>Stagg</u>
Assets:		
Cash	\$ 925,000	\$ 300,000
Accounts and other receivables	2,140,000	835,000
Inventories	2,310,000	1,045,000
Land	600,000	330,000
Depreciable assets, net	4,525,000	1,980,000
Investment in Stagg, Inc.	2,430,000	—
Long-term investments and other assets	865,000	385,000
	<u>\$13,795,000</u>	<u>\$4,875,000</u>
Liabilities and Stockholders' Equity:		
Accounts payable and other current liabilities	\$ 2,465,000	\$1,145,000
Long-term debt	1,900,000	1,300,000
Common stock, \$25 par value	3,200,000	1,000,000
Additional paid-in capital	1,850,000	190,000
Retained earnings	4,380,000	1,240,000
	<u>\$13,795,000</u>	<u>\$4,875,000</u>

Additional information is as follows:

- Peel uses the equity method of accounting for its investment in Stagg. The investment in Stagg has not been adjusted for any intercompany transactions.
- On June 30, 1987, Stagg's assets and liabilities had fair values equal to the book balances with the exception of land, which had a fair value of \$550,000.

- On June 15, 1987, Stagg paid a cash dividend of \$4 per share on its common stock.
- On December 10, 1987, Peel paid a cash dividend totaling \$256,000 on its common stock.
- On June 30, 1987, immediately before the combination, the stockholders' equities were:

	<u>Peel</u>	<u>Stagg</u>
Common stock	\$2,200,000	\$1,000,000
Additional paid-in capital	1,660,000	190,000
Retained earnings	3,036,000	980,000
	<u>\$6,896,000</u>	<u>\$2,170,000</u>

- Stagg's long-term debt consisted of 10% ten-year bonds issued at face value on March 31, 1981. Interest is payable semiannually on March 31 and September 30. Peel had purchased Stagg's bonds at face value of \$320,000 in 1981, and there was no change in ownership through December 31, 1987.
- During October 1987 Peel sold merchandise to Stagg at an aggregate invoice price of \$720,000, which included a profit of \$180,000. At December 31, 1987, one-half of the merchandise remained in Stagg's inventory, and Stagg had not paid Peel for the merchandise purchased.
- Stagg's 1987 net income was \$580,000. Peel's 1987 income before considering equity in Stagg's net income was \$890,000.
- The balances in retained earnings at December 31, 1986, were \$2,506,000 and \$820,000 for Peel and Stagg, respectively.

Required:

Go to page AP-162 and remove tear-out worksheet.

a. Complete the tear-out worksheet to prepare a consolidated balance sheet of Peel, Inc., and its subsidiary, Stagg, Inc., at December 31, 1987. A formal consolidated balance sheet and journal entries are not required. Include the completed tear-out worksheet in the proper sequence with other answer sheets.

b. Prepare a formal consolidated statement of retained earnings for the year ended December 31, 1987.

1N88
Number 5 (cont.)

Candidate's No. _____
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Peel, Inc. and Subsidiary
CONSOLIDATED BALANCE SHEET WORKSHEET
December 31, 1987

	<i>Peel, Inc.</i>	<i>Stagg, Inc.</i>	<i>Adjustments & Eliminations</i>		<i>Consolidated Balance</i>
			<i>Debit</i>	<i>Credit</i>	
<i>Assets:</i>					
Cash	\$ 925,000	\$ 300,000			
Accounts and other receivables	2,140,000	835,000			
Inventories	2,310,000	1,045,000			
Land	600,000	330,000			
Depreciable assets, net	4,525,000	1,980,000			
Investment in Stagg, Inc.	2,430,000				
Long-term investments and other assets	865,000	385,000			
	\$13,795,000	\$4,875,000			
<i>Liabilities and stockholders' equity:</i>					
Accounts payable and other current liabilities	\$2,465,000	\$1,145,000			
Long-term debt	1,900,000	1,300,000			
Common stock, \$25 par value	3,200,000	1,000,000			
Additional paid-in capital	1,850,000	190,000			
Retained earnings	4,380,000	1,240,000			
	\$13,795,000	\$4,875,000			

Selected Questions

2N87

Number 5 (Estimated time — — 40 to 50 minutes)

The December 31, 1986 condensed balance sheets of Pym Corp. and its 90%-owned subsidiary, Sy Corp., are presented in the tear-out worksheet. Additional information follows:

- Pym's investment in Sy was purchased for \$1,200,000 cash on January 1, 1986, and is accounted for by the equity method.
- At January 1, 1986, Sy's retained earnings amounted to \$600,000, and its common stock amounted to \$200,000.
- Sy declared a \$1,000 cash dividend in December 1986, payable in January 1987.
- As of December 31, 1986, Pym had not recorded any portion of Sy's 1986 net income or dividend declaration.
- Sy borrowed \$100,000 from Pym on June 30, 1986, with the note maturing on June 30, 1987, at 10% interest. Correct accruals have been recorded by both companies.
- During 1986, Pym sold merchandise to Sy at an aggregate invoice price of \$300,000, which included a profit of \$60,000. At December 31, 1986, Sy had not paid Pym for \$90,000 of these purchases, and 5% of the total merchandise purchased from Pym still remained in Sy's inventory.
- Pym's excess cost over book value of Pym's investment in Sy has appropriately been identified as goodwill and is to be amortized over 10 years.

Required:

Complete the tear-out worksheet for Pym Corp. and its subsidiary, Sy Corp., at December 31, 1986.

A formal consolidated balance sheet and journal entries are not required. Include the completed tear-out worksheet in the proper sequence with your other answer sheets.

2N87
Number 5 (cont.)

Candidate's No. _____
State _____
Question No. 5 Page _____

Pym Corp. and Subsidiary
CONSOLIDATED BALANCE SHEET WORKSHEET
December 31, 1986

	<i>Pym Corp.</i>	<i>Sy Corp.</i>	<i>Adjustments & Eliminations</i>		<i>Consolidated</i>
			<i>Debit</i>	<i>Credit</i>	
<i>Assets</i>					
Cash	75,000	15,000			
Accounts and other current receivables	410,000	120,000			
Merchandise inventory	920,000	670,000			
Plant and equipment (net)	1,000,000	400,000			
Investment in Sy Corp.	1,200,000				
Totals	3,605,000	1,205,000			
<i>Liabilities and Stockholders' Equity</i>					
Accounts payable and other current liabilities	140,000	305,000			
Common stock (\$10 par)	500,000	200,000			
Retained earnings	2,965,000	700,000			
Totals	3,605,000	1,205,000			

Selected Questions

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

A. Cash, Marketable Securities, and Investments

1M89

Number 5 (Estimated time — 40 to 50 minutes)

At December 31, 1987, Poe Corp. properly reported as current assets the following marketable equity securities:

Axe Corp., 1,000 shares, \$2.40 convertible preferred stock	\$ 40,000
Purl Inc., 6,000 shares of common stock	60,000
Day Co., 2,000 shares of common stock	55,000
Marketable equity securities at cost	155,000
Less valuation allowance	7,000
Marketable equity securities at market value	<u>\$148,000</u>

On January 2, 1988, Poe purchased 100,000 shares of Scott Corp. common stock for \$1,700,000, representing 30% of Scott's outstanding common stock and an underlying equity of \$1,400,000 in Scott's net assets on January 2. Poe, which had no other financial transactions with Scott during 1988, amortizes goodwill over a 40-year period. As a result of Poe's 30% ownership of Scott, Poe has the ability to exercise significant influence over Scott's financial and operating policies.

During 1988, Poe disposed of the following securities:

- January 18 — sold 2,500 shares of Purl for \$13 per share.
- June 1 — sold 500 shares of Day, after a 10% stock dividend was received, for \$21 per share.
- October 1 — converted 500 shares of Axe's preferred stock into 1,500 shares of Axe's common stock, when the market price was \$60 per share for the preferred stock and \$21 per share for the common stock.

The following 1988 dividend information pertains to stock owned by Poe:

- February 14 — Day issued a 10% stock dividend, when the market price of Day's common stock was \$22 per share.
- April 5 and October 5 — Axe paid dividends of \$1.20 per share on its \$2.40 preferred stock, to stockholders of record on March 9 and September 9, respectively. Axe did not pay dividends on its common stock during 1988.
- June 30 — Purl paid a \$1.00 per share dividend on its common stock.
- March 1, June 1, September 1, and December 1 — Scott paid quarterly dividends of \$0.50 per share on each of these dates. Scott's net income for the year ended December 31, 1988 was \$1,200,000.

At December 31, 1988, Poe's management intended to hold Scott's stock as a long-term investment, with the remaining investments being considered as temporary. Market prices per share of the marketable equity securities were as follows:

	<u>At December 31,</u>	
	<u>1988</u>	<u>1987</u>
Axe Corp. — preferred	\$56	\$42
Axe Corp. — common	20	18
Purl, Inc. — common	11	11
Day Co. — common	22	20
Scott Corp. — common	16	18

All of the foregoing stocks are listed on major stock exchanges. Declines in market value from cost would not be considered permanent.

Required:

- a. Prepare a schedule of Poe's *current* marketable equity securities at December 31, 1988, including any information necessary to determine the related valuation allowance and unrealized gains and losses.
- b. Prepare a schedule to show the carrying amount of Poe's *noncurrent* marketable equity securities at December 31, 1988.
- c. Prepare a schedule showing all revenue, gains, and losses (realized and unrealized) relating to Poe's investments for the year ended December 31, 1988.

1N86

Number 4 (Estimated time — 45 to 55 minutes)

On December 31, 1984, Lee, Inc., reported as long-term investments the following marketable equity securities:

Dale Corp., 5,000 shares of common stock (a 1% interest)	\$125,000
Ewing Corp., 10,000 shares of common stock (a 2% interest)	160,000
Fox Corp., 25,000 shares of common stock (a 10% interest)	<u>700,000</u>
Marketable equity securities at cost	985,000
Less valuation allowance to reduce long-term investments in marketable equity securities to market value	<u>50,000</u>
Marketable equity securities at market	<u>\$935,000</u>

1N86

Number 4 (cont.)

Additional information:

- On May 1, 1985, Dale issued a 10% stock dividend, when the market price of its stock was \$24 per share.
- On November 1, 1985, Dale paid a cash dividend of \$0.75 per share.
- On August 5, 1985, Ewing issued, to all shareholders, stock rights on the basis of one right per share. Market prices at date of issue were \$13.50 per share (ex-rights) of stock and \$1.50 per right. Lee sold all rights on December 16, 1985, for net proceeds of \$18,800.
- On July 1, 1985, Lee paid \$1,520,000 for 50,000 additional shares of Fox Corp.'s common stock which represented a 20% investment in Fox. The fair value of all of Fox's identifiable assets net of liabilities was equal to their carrying amount of \$6,350,000. As a result of this transaction, Lee owns 30% of Fox and can exercise significant influence over Fox's operating and financial policies. Lee amortizes goodwill over a 40-year period.
- Lee's initial 10% interest of 25,000 shares of Fox's common stock was acquired on January 2, 1984, for \$700,000. At that date the net assets of Fox totaled \$5,800,000 and the fair value of Fox's identifiable assets net of liabilities was equal to their carrying amount.
- Market prices per share of the marketable equity securities, all listed on a national securities exchange, were as follows:

	<u>December 31,</u>	
	<u>1984</u>	<u>1985</u>
Dale Corp. — common	\$22	\$23
Ewing Corp. — common	15	14
Fox Corp. — common	27	29

- Fox reported net income and paid dividends of:

	<u>Net income</u>	<u>Dividends per share</u>
Year ended 12/31/84	\$350,000	None
Six months ended 6/30/85	200,000	None
Six months ended 12/31/85	370,000	\$1.30
(Dividend was paid 10/1/85)		

- There were no other intercompany transactions between Lee and Fox.

Required:

- Prepare a schedule setting forth for each investment the transactions and computations necessary to determine the ending balance in Lee's December 31, 1985, balance sheet:
 - For investments carried at the lower of cost or market.
 - For investments carried under the equity method of accounting.
- Prepare a schedule showing all income, gains, and losses relating to Lee's long-term investments for the year ended December 31, 1985.

B. Receivables and Accruals

1M88

Number 5 (Estimated time — — 40 to 50 minutes)

Among the account balances of Rowe Corp. at December 31, 1986, are the following:

Patent, net of accumulated patent amortization	\$245,000
Installment contract receivable, including current portion	720,000

In its year-end financial statements, Rowe reports as other noncurrent assets all assets that are not classified as property, plant, and equipment or as current assets. Relevant transactions and other information for 1987 were as follows:

- The patent was purchased from Lake Co. for \$315,000 on September 1, 1983. On that date the remaining legal life was 15 years, which was also determined to be the useful life.
- The installment contract receivable represents the balance of the consideration received from the sale of a factory building to Pitt Co. on March 31, 1985, for \$1,200,000. Pitt made a \$300,000 down payment and signed a five-year 13% note for the \$900,000 balance. The first of equal annual principal payments of \$180,000 was received on March 31, 1986, together with interest to that date. The note is collateralized by the factory building with a fair value of \$1,000,000 at December 31, 1986, and December 31, 1987. The 1987 payment was received on time.
- On January 2, 1987, Rowe purchased a trademark from Kerr Corp. for \$250,000. Rowe considers the life of the trademark to be indefinite. The trademark will be amortized over the maximum period allowable.

Selected Questions

- On May 1, 1987, Rowe sold the patent to Strand Co. in exchange for a \$500,000 noninterest bearing note due on May 1, 1990. There was no established exchange price for the patent, and the note had no ready market. The prevailing rate of interest for a note of this type at May 1, 1987 was 14%. The present value of 1 for three periods at 14% is 0.675. The collection of the note receivable from Strand is reasonably assured.
- On July 1, 1987, Rowe paid \$1,880,000 for 75,000 shares of Black Corp.'s common stock, which represented a 25% investment in Black. The fair value of all of Black's identifiable assets net of liabilities equals their carrying amount of \$6,400,000. Rowe has the ability to exercise significant influence over Black's operating and financial policies. Rowe amortizes goodwill over a 40-year period. The market price of Black's common stock on December 31, 1987 was \$26.50 per share.
- Black reported net income and paid dividends of:

	<i>Net income</i>	<i>Dividends per share</i>
Six months ended 6/30/87	\$576,000	None
Six months ended 12/31/87	704,000	\$2.00
(Dividend was paid 11/30/87)		

- Rowe and Black had no other intercompany transactions.

Required:

- Prepare a separate schedule of changes for each of the other noncurrent asset accounts during 1987.
- Prepare a schedule showing the revenues, gains, and expenses relating to Rowe's other noncurrent assets for the year ended December 31, 1987.

D. Property, Plant, and Equipment Owned or Leased

1N88

Number 4 (Estimated time — 45 to 55 minutes)

At December 31, 1986, Cord Company's plant asset and accumulated depreciation and amortization accounts had balances as follows:

<i>Category</i>	<i>Plant asset</i>	<i>Accumulated depreciation and amortization</i>
Land	\$ 175,000	\$ —
Buildings	1,500,000	328,900
Machinery and equipment	1,125,000	317,500
Automobiles and trucks	172,000	100,325
Leasehold improvements	216,000	108,000
Land improvements	—	—

Depreciation methods and useful lives

Buildings — 150% declining balance; 25 years.
 Machinery and equipment — Straight-line; 10 years.
 Automobiles and trucks — 150% declining balance; five years, all acquired after 1983.
 Leasehold improvements — Straight-line.
 Land improvements — Straight-line.
 Depreciation is computed to the nearest month.
 The salvage values of the depreciable assets are immaterial.

Transactions during 1987 and other information

- On January 6, 1987, a plant facility consisting of land and building was acquired from King Corp. in exchange for 25,000 shares of Cord's common stock. On this date, Cord's stock had a market price of \$50 a share. Current assessed values of land and building for property tax purposes are \$187,500 and \$562,500, respectively.
- On March 25, 1987, new parking lots, streets, and sidewalks at the acquired plant facility were completed at a total cost of \$192,000. These expenditures had an estimated useful life of 12 years.
- The leasehold improvements were completed on December 31, 1983, and had an estimated useful life of eight years. The related lease, which would have terminated on December 31, 1989, was renewable for an additional four-year term. On April 29, 1987, Cord exercised the renewal option.
- On July 1, 1987, machinery and equipment were purchased at a total invoice cost of \$325,000. Additional costs of \$10,000 for delivery and \$50,000 for installation were incurred.
- On August 30, 1987, Cord purchased a new automobile for \$12,500.
- On September 30, 1987, a truck with a cost of \$24,000 and a carrying amount of \$9,100 on date of sale was sold for \$11,500. Depreciation for the 9 months ended September 30, 1987 was \$2,650.
- On November 4, 1987, Cord purchased for \$350,000 a tract of land as a potential future building site.
- On December 20, 1987, a machine with a cost of \$17,000 and a carrying amount of \$2,975 at date of disposition was scrapped without cash recovery.

Required:

- Prepare a schedule analyzing the changes in each of the plant asset accounts during 1987. This schedule should include columns for beginning balance, increase, decrease and ending balance for each of the plant asset accounts. **Do not analyze changes in accumulated depreciation and amortization accounts.**

- For each asset category, prepare a schedule showing depreciation or amortization expense for the year ended December 31, 1987. **Round computations to the nearest whole dollar.**

Accounting Practice

1N87

Number 4 (Estimated time — 40 to 50 minutes)

The plant asset and accumulated depreciation accounts of Pell Corporation had the following balances at December 31, 1985:

	<i>Plant asset</i>	<i>Accumulated depreciation</i>
Land	\$ 350,000	\$ —
Land improvements	180,000	45,000
Building	1,500,000	350,000
Machinery and equipment	1,158,000	405,000
Automobiles	150,000	112,000

Depreciation methods and useful lives

Land improvements — Straight-line; 15 years.

Building — 150% declining balance; 20 years.

Machinery and equipment — Straight-line; ten years.

Automobiles — 150% declining balance; three years.

Depreciation is computed to the nearest month. No salvage values are recognized.

Transactions during 1986

- On January 2, 1986, machinery and equipment were purchased at a total invoice cost of \$260,000, which included a \$5,500 charge for freight. Installation costs of \$27,000 were incurred.
- On March 31, 1986, a machine purchased for \$58,000 on January 2, 1982, was sold for \$36,500.
- On May 1, 1986, expenditures of \$50,000 were made to repave parking lots at Pell's plant location. The work was necessitated by damage caused by severe winter weather.
- On November 1, 1986, Pell acquired a tract of land with an existing building in exchange for 10,000 shares of Pell's \$20 par common stock, that had a market price of \$38 a share on this date. Pell paid legal fees and title insurance totaling \$23,000. The last property tax bill indicated assessed values of \$240,000 for land and \$60,000 for building. Shortly after acquisition, the building was razed at a cost of \$35,000 in anticipation of new building construction in 1987.
- On December 31, 1986, Pell purchased a new automobile for \$15,250 cash and trade-in of an automobile purchased for \$18,000 on January 2, 1985. The new automobile has a cash value of \$19,000.

Required:

a. Prepare a schedule analyzing the changes in each of the plant assets during 1986, with detailed supporting computations. **Disregard the related accumulated depreciation accounts.**

b. For each asset classification, prepare a schedule showing depreciation expense for the year ended December 31, 1986.

c. Prepare a schedule showing the gain or loss from each asset disposal that would be recognized in Pell's income statement for the year ended December 31, 1986.

1M85

Number 4 (Estimated time — 45 to 55 minutes)

Information pertaining to Blake Corporation's property, plant and equipment for 1984 is presented below.

Account balances at January 1, 1984

	<i>Debit</i>	<i>Credit</i>
Land	\$ 150,000	
Building	1,200,000	
Accumulated depreciation		\$263,100
Machinery and equipment	900,000	
Accumulated depreciation		250,000
Automotive equipment	115,000	
Accumulated depreciation		84,600

Depreciation method and useful life

Building — 150% declining balance; 25 years.

Machinery and equipment — Straight-line; ten years.

Automotive equipment — Sum-of-the-years'-digits; four years.

Leasehold improvements — Straight-line.

The salvage value of the depreciable assets is immaterial.

Depreciation is computed to the nearest month.

Transactions during 1984 and other information

On January 2, 1984, Blake purchased a new car for \$10,000 cash and trade-in of a two-year-old car with a cost of \$9,000 and a book value of \$2,700. The new car has a cash price of \$12,000; the market value of the trade-in is not known.

On April 1, 1984, a machine purchased for \$23,000 on April 1, 1979, was destroyed by fire. Blake recovered \$15,500 from its insurance company.

On May 1, 1984, costs of \$168,000 were incurred to improve leased office premises. The leasehold improvements have a useful life of eight years. The related lease, which terminates on December 31, 1990, is renewable for an additional six-year term. The decision to renew will be made in 1990 based on office space needs at that time.

Selected Questions

On July 1, 1984, machinery and equipment were purchased at a total invoice cost of \$280,000; additional costs of \$5,000 for freight and \$25,000 for installation were incurred.

Blake determined that the automotive equipment comprising the \$115,000 balance at January 1, 1984, would have been depreciated at a total amount of \$18,000 for the year ended December 31, 1984.

Required:

a. For each asset classification prepare schedules showing depreciation and amortization expense, and accumulated depreciation and amortization that would appear on Blake's income statement for the year ended December 31, 1984, and balance sheet at December 31, 1984, respectively.

b. Prepare a schedule showing gain or loss from disposal of assets that would appear in Blake's income statement for the year ended December 31, 1984.

c. Prepare the property, plant and equipment section of Blake's December 31, 1984, balance sheet.

E. Intangibles and Other Assets

1N85

Number 4 (Estimated time — — 45 to 55 minutes)

Munn, Inc., had the following other noncurrent asset account balances at December 31, 1983:

Patent	\$192,000
Accumulated amortization	(24,000)
Deferred income tax charges	36,000

Munn reports as other noncurrent assets any assets that are either intangible or not used directly in its operations.

Transactions during 1984 and other information relating to Munn's other noncurrent assets were as follows:

- The patent was purchased from Grey Company for \$192,000 on January 1, 1982, at which date the remaining legal life was 16 years. On January 1, 1984, Munn determined that the useful life of the patent was only eight years from the date of acquisition.

- Deferred income taxes are provided in recognition of timing differences between financial statement and income tax reporting of rent income and warranty expense. The rent received in advance and warranty liability are appropriately considered noncurrent items. For the year ended December 31, 1984: (1) rent collected in advance decreased by \$20,000, and (2) product warranty liability increased by \$15,000. Munn's income tax rate for 1984 was 40%.

- On January 3, 1984, in connection with the purchase of a trademark from Cody Corporation, the parties entered into a non-competition agreement and a consulting contract. Munn paid Cody \$800,000, of which three-quarters was for the trademark, and one-quarter was for Cody's agreement not to compete for a five-year period in the line of business covered by the trademark. Munn considers the life of the trademark to be indefinite. Under the consulting contract, Munn agreed to pay Cody \$50,000 annually on January 3 for five years. The first payment was made on January 3, 1984.

- On July 1, 1984, Munn purchased as a long-term investment \$1,000,000 face value of Dell Corporation original issue 8% bonds for \$923,000. The bonds, which were priced to yield 10%, pay interest semi-annually on January 1 and July 1, and mature on July 1, 1989. Munn uses the interest method of amortization.

Required:

a. Prepare a schedule of the expenses for 1984 relating to Munn's other noncurrent asset balances at December 31, 1983, and transactions during 1984. Include in the schedule the deferred income tax charge or credit portion of Munn's total 1984 income tax expense.

b. Prepare the other noncurrent assets section of Munn's balance sheet at December 31, 1984.

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

2N88

Number 4 (Estimated time — 45 to 55 minutes)

Lino Corporation's liability account balances at December 31, 1986 included the following:

Note payable to bank	\$800,000
Liability under capital lease	280,000
Deferred income taxes	100,000

Additional information:

- The note payable, dated October 1, 1986, bears interest at an annual rate of 10% payable semi-annually on April 1 and October 1. Principal payments are due annually on October 1 in four equal installments.
- The capital lease is for a 10-year period beginning December 31, 1981. Equal annual payments of \$100,000 are due on December 31 of each year. The 16% interest rate implicit in the lease is known by Lino. At December 31, 1986, the present value of the four remaining lease payments discounted at 16% was \$280,000.
- Deferred income taxes are provided in recognition of timing differences between financial statement and income tax reporting of depreciation. For the year ended December 31, 1987, depreciation per tax return exceeded book depreciation by \$50,000. Lino's income tax rate for 1987 was 30%.
- On July 1, 1987, Lino issued \$1,000,000 face amount of 10-year, 10% bonds for \$750,000, to yield 15%. Interest is payable annually on July 1. Bond discount is amortized by the interest method.
- All required principal and interest payments were made on schedule in 1987.

Required:

a. Prepare the long-term liabilities section of Lino's balance sheet at December 31, 1987.

b. Prepare a schedule showing interest expense that should appear in Lino's income statement for the year ended December 31, 1987.

1M88

Number 4 (Estimated time — 45 to 55 minutes)

Fay, Inc. finances its capital needs approximately one-third from long-term debt and two-thirds from equity. At December 31, 1986, Fay had the following liability and equity account balances:

11% Debenture bonds payable, face amount	\$5,000,000
Premium on bonds payable	352,400
Common stock	8,000,000

Additional paid-in capital	2,295,000
Retained earnings	2,465,000
Treasury stock, at cost	325,000

Transactions during 1987 and other information relating to Fay's liabilities and equity accounts were as follows:

- The debenture bonds were issued on December 31, 1984, for \$5,378,000 to yield 10%. The bonds mature on December 31, 1999. Interest is payable annually on December 31. Fay uses the interest method to amortize bond premium.
- Fay's common stock shares are traded on the over-the-counter market. At December 31, 1986, Fay had 2,000,000 authorized shares of \$10 par common stock.
- On January 15, 1987, Fay reissued 15,000 of its 25,000 shares of treasury stock for \$225,000. The treasury stock had been acquired on February 28, 1986.
- On March 2, 1987, Fay issued a 5% stock dividend on all issued shares. The market price of Fay's common stock at time of issuance was \$14 per share.
- On November 1, 1987, Fay borrowed \$4,000,000 at 9%, evidenced by an unsecured note payable to United Bank. The note is payable in five equal annual principal installments of \$800,000. The first principal and interest payment is due on November 1, 1988.
- On December 31, 1987, Fay owned 10,000 shares of Ryan Corp.'s common stock, which represented a 1% ownership interest. Fay accounts for this marketable equity investment as a long-term investment. The stock was purchased on May 1, 1986, at \$20 per share. The market price was \$21 per share on December 31, 1986, and \$18 per share on December 31, 1987.
- Fay's net income for 1987 was \$2,860,000.

Required (Include formal schedules of supporting computations with each item referenced to correspond with the items in the solution):

a. Prepare the long-term liabilities section of Fay's December 31, 1987 balance sheet, including all disclosures applicable to each obligation.

b. Prepare the stockholders' equity section of Fay's December 31, 1987 balance sheet.

c. Prepare a schedule showing interest expense for the year ended December 31, 1987.

Selected Questions

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

A. Preferred and Common Stock

1M86

Number 4 (Estimated time — 45 to 55 minutes)

Carr Corporation had the following stockholders' equity account balances at December 31, 1984:

Preferred stock	\$1,800,000
Additional paid-in capital from preferred stock	90,000
Common stock	5,150,000
Additional paid-in capital from common stock	3,500,000
Retained earnings	4,000,000
Net unrealized loss on noncurrent marketable equity securities	245,000
Treasury common stock	270,000

Transactions during 1985 and other information relating to the stockholders' equity accounts were as follows:

- Carr's preferred and common shares are traded on the over-the-counter market. At December 31, 1984, Carr had 100,000 authorized shares of \$100 par, 10% cumulative preferred stock; and 3,000,000 authorized shares of no par common stock with a stated value of \$5 per share.

- On January 10, 1985, Carr formally retired all 30,000 shares of its treasury common stock and had them revert to an unissued basis. The treasury stock had been acquired on January 20, 1984. The shares were originally issued at \$10 per share.

- Carr owned 10,000 shares of Bush, Inc., common stock purchased in 1982 for \$750,000. The Bush stock was included in Carr's short-term marketable securities portfolio. On February 15, 1985, Carr declared a dividend in kind of one share of Bush for every hundred shares of Carr common stock held by a stockholder of record on February 28, 1985. The market price of Bush common stock was \$63 per share on February 15, 1985. The dividend in kind was distributed on March 12, 1985.

- On April 1, 1985, 250,000 stock rights were issued to the common stockholders permitting the purchase of one new share of common stock in exchange for one right and \$11 cash. On April 25, 1985, 210,000 stock rights were exercised when the market price of Carr's common stock was \$13 per share. Carr issued new shares to settle the transaction. The remaining 40,000 rights were not exercised and expired.

- On January 1, 1982, Carr granted stock options to employees for the purchase of 100,000 shares of the company's common stock at \$8 per share which was also the market price. The options are exercisable within a three-year period beginning January 1, 1984. The measurement date is the same as the grant date. On July 1, 1985, employees exercised 80,000 options for \$8 per share. On July 1, 1985, the market price of Carr's common stock was \$15 per share. Carr used new shares to settle the transaction.

- On December 12, 1985, Carr declared the yearly cash dividend on preferred stock, payable on January 14, 1986, to stockholders of record on December 31, 1985.

- After year-end adjustment the Net Unrealized Loss on Noncurrent Marketable Equity Securities account had a debit balance of \$135,000 at December 31, 1985.

- On January 15, 1986, before the accounting records were closed for 1985, Carr became aware that rent income for the year ended December 31, 1984, was overstated by \$500,000. The after tax effect on 1984 net income was \$275,000. The appropriate correcting entry was recorded the same day.

- After correcting the rent income, net income for 1985 was \$2,600,000.

Required:

- a. Prepare Carr's statement of retained earnings for the year ended December 31, 1985. Assume that only single-period financial statements for 1985 are presented.

- b. Prepare the stockholders' equity section of Carr's balance sheet at December 31, 1985.

VII. Cost Accumulation, Planning, and Control

2M89

Number 5 (Estimated time — — 40 to 50 minutes)

The following information pertains to the pricing and delivery functions of Tapa Wholesale Company:

Number of sales made to customers in 1988	20,000
Average number of items per sale in 1988	4
Number of sales projected for 1989	24,000
Average number of items per sale projected for 1989	5

Sales invoices are priced by clerks whose wage rate is \$6.00 per hour. Labor negotiations have resulted in a 10% increase in the hourly rate for 1989. It is expected that Tapa's pricing function will operate at the same level of productivity in 1989 as it did in 1988. Payroll tax rates and workers' compensation insurance rates will be the same in 1989 as in 1988. Prices for various items of supplies are expected to be the same in 1989 as in 1988.

The following costs were charged to Tapa's pricing function in 1988:

Variable:	
Wages	\$40,000
Payroll taxes	4,000
Workers' compensation insurance	2,000
Supplies	1,000
Total variable	47,000
Fixed	3,400
Total costs	<u>\$50,400</u>

Fixed costs are allocated equally to all units. Except for delivery costs, all variable costs vary directly with the number of items priced. Supplies increase in proportion to the increase in the number of items priced. Tapa sells three products: Arcil, Balo, and Cacha. Differences in size and weight among these products affect variable delivery costs. For example, truck capacity is 10 units of Arcil, or 5 units of Balo, or 4 units of Cacha. Units projected to be delivered in 1989 are as follows:

Arcil	60,000
Balo	40,000
Cacha	20,000
Total	<u>120,000</u>

Projected 1989 costs for the delivery function are as follows:

Variable	\$228,000
Fixed	30,000

Required:

a. Prepare the 1989 budget of all costs for Tapa's pricing function.

b. Prepare a schedule showing the 1989 standard delivery cost per unit of each of the three products sold by Tapa.

Selected Questions

2N88

Number 5 (Estimated time — — 40 to 50 minutes)

Amar Supermarkets Corp. operates a chain of three retail stores in a state that permits municipalities to levy an income tax on businesses operating within their respective boundaries. The tax rate is uniform in all of the municipalities that levy the tax, and does not vary according to taxable income. Regulations provide that the tax is to be computed on income earned within the particular taxing municipality, after reasonable and consistent allocation of the corporation's overhead. Amar's overhead consists of expenses pertaining to the warehouse, central office, advertising, and delivery.

For the year ended December 31, 1987, operating results for each store, before taxes and allocation of corporation overhead, were as follows:

	<i>Birch</i>	<i>Maple</i>	<i>Spruce</i>	<i>Total</i>
Sales	\$500,000	\$400,000	\$300,000	\$1,200,000
Cost of sales	280,000	230,000	190,000	700,000
Gross margin	220,000	170,000	110,000	500,000
Local operating expenses				
Fixed	70,000	60,000	50,000	180,000
Variable	66,000	73,000	31,000	170,000
Totals	136,000	133,000	81,000	350,000
Income before corporation overhead and taxes	<u>\$ 84,000</u>	<u>\$ 37,000</u>	<u>\$ 29,000</u>	<u>\$ 150,000</u>

For the year ended December 31, 1987, corporation overhead was as follows:

Warehouse and delivery		
Warehouse depreciation	\$10,000	
Warehouse operations	15,000	
Delivery	35,000	\$ 60,000
Central office		
Advertising	\$ 8,000	
Salaries	30,000	
Other	2,000	40,000
Total corporation overhead		<u>\$100,000</u>

Delivery expenses vary with distances from the warehouse and numbers of deliveries to stores. Delivery statistics for 1987 are as follows:

<i>Store</i>	<i>Miles from warehouse</i>	<i>Number of deliveries</i>	<i>Delivery miles</i>
Birch	100	150	15,000
Maple	200	50	10,000
Spruce	25	200	5,000

Management has engaged a CPA firm to evaluate two corporation overhead allocation plans that are being considered, so that operating results under both plans can be compared. In addition, management has decided to expand one of the stores in a plan to increase sales by \$80,000. The contemplated expansion is expected to increase local fixed operating costs by \$8,000 and to require 10 additional deliveries from the warehouse. The CPA firm has been requested to furnish management with a recommendation as to which store should be selected for the prospective expansion.

2N88

Number 5 (cont.)

Required:

a. Rounding off to the nearest whole percent, compute each store's income that would be subject to the municipal income tax under the following two plans:

Plan 1. Allocate all corporation overhead on the basis of sales.

Plan 2. Allocate central office salaries and other central office overhead equally to warehouse operations and to each store. Then, allocate the resulting warehouse operations costs, warehouse depreciation, and advertising to each store on the basis of sales. Finally, allocate delivery expenses to each store on the basis of delivery miles.

b. Compute each store's increase in relevant expenses, including delivery expenses, but before allocation of other corporation overhead and taxes as a result of the contemplated expansion. Determine which of the three stores should be selected for expansion to maximize corporate net income.

2M88

Number 5 (Estimated time — 40 to 50 minutes)

Seco Corp., a wholesale supply company, engages independent sales agents to market the company's lines. These agents currently receive a commission of 20% of sales, but they are demanding an increase to 25% of sales made during the year ending December 31, 1989. Seco had already prepared its 1989 budget before learning of the agents' demand for an increase in commissions. The following pro forma income statement is based on this budget:

Seco Corp.
PRO FORMA INCOME STATEMENT
For the Year Ending December 31, 1989

Sales		\$10,000,000
Cost of sales		<u>6,000,000</u>
Gross margin		4,000,000
Selling and administrative costs		
Commissions	\$2,000,000	
All other costs (fixed)	<u>100,000</u>	<u>2,100,000</u>
Income before income tax		1,900,000
Income tax (30%)		<u>570,000</u>
Net income		<u>\$ 1,330,000</u>

Seco is considering the possibility of employing its own salespersons. Three individuals would be required, at an estimated annual salary of \$30,000 each, plus commissions of 5% of sales. In addition, a sales manager would be employed at a fixed annual salary of \$160,000. All other fixed costs, as well as the variable cost percentages, would remain the same as the estimates in the 1989 pro forma income statement.

Required:

a. Compute Seco's estimated breakeven point in sales dollars for the year ending December 31, 1989

based on the pro forma income statement prepared by the company.

b. Compute Seco's estimated breakeven point in sales dollars for the year ending December 31, 1989 if the company employs its own salespersons.

c. Compute the estimated volume in sales dollars that would be required for the year ending December 31, 1989 to yield the same net income as projected in the pro forma income statement, if Seco continues to use the independent sales agents and agrees to their demand for a 25% sales commission.

d. Compute the estimated volume in sales dollars that would generate an identical net income for the year ending December 31, 1989, regardless of whether Seco employs its own salespersons or continues to use the independent sales agents and pays them a 25% commission.

2N87

Number 4 (Estimated time — 45 to 55 minutes)

Webb & Company is engaged in the preparation of income tax returns for individuals. Webb uses the weighted average method and actual costs for financial reporting purposes. However, for internal reporting, Webb uses a standard cost system. The standards, based on equivalent performance, have been established as follows:

Labor per return	5 hrs. @ \$20 per hr.
Overhead per return	5 hrs. @ \$10 per hr.

For March 1987 performance, budgeted overhead is \$49,000 for the standard labor hours allowed. The following additional information pertains to the month of March 1987:

Selected Questions

Inventory data

Returns in process, March 1 (25% complete)	200
Returns started in March	825
Returns in process, March 31 (80% complete)	125

Actual cost data

Returns in process, March 1:	
Labor	\$ 6,000
Overhead	2,500
Labor, March 1 to 31 4,000 hours	89,000
Overhead, March 1 to 31	45,000

Required:

a. Using the weighted average method, compute the following for each cost element:

- (1) Equivalent units of performance.
- (2) Actual cost per equivalent unit.

b. Compute the actual cost of returns in process at March 31.

c. Compute the standard cost per return.

d. Prepare a schedule for internal reporting analyzing March performance, using the following variances, and indicating whether these variances are favorable or unfavorable:

- (1) Total labor.
- (2) Labor rate.
- (3) Labor efficiency.
- (4) Total overhead.
- (5) Overhead volume.
- (6) Overhead budget.

2N85

Number 5 (Estimated time — 40 to 50 minutes)

Leif Company is faced with the necessity of making the following three unrelated financial management decisions involving its Sigma Division:

a. *Establishment of a selling price for a new product, called Kace, developed by Sigma.* Kace's variable cost is \$3 per unit. The following probabilities of reaching annual sales levels for Kace have been estimated:

Sales (in units)	If each unit is sold for		
	\$6	\$7	\$8
70,000	10%	40%	70%
80,000	50%	30%	20%
90,000	40%	30%	10%

b. *Discontinuance of a currently produced product and acquisition of a new machine.* Sigma's manager, Baum, has recommended that an unprofitable product, called Sago, be discontinued, which would decrease Sigma's current sales volume by 10%. In addition, Baum wants to improve efficiency by investing \$100,000 in a new machine. Baum believes that implementation of his two recommendations would increase the pre-tax income rate on sales to 12%.

Sigma's current rate of pre-tax income is 10% on annual sales of \$2,000,000. Financing of these current annual sales requires an investment of \$600,000. Leif measures Sigma's performance by the pre-tax accounting rate of return based on the initial investment.

c. *Financing of a distributor.* Cote Corp., which is one of Sigma's distributors, wants to borrow \$200,000 from Leif and to repay this loan within three years. As an inducement, Cote is offering Leif a participation in Cote's income for three years. Payments by Cote at the end of each of the three years would include principal plus 5% of Cote's net income for each of these years. The estimated amounts to be remitted by Cote to Leif under this arrangement would be as follows:

<u>At the end of year</u>	<u>Amount</u>
1	\$ 50,000
2	90,000
3	110,000
Total estimated remittances	<u>\$250,000</u>

Leif would be willing to grant Cote's loan request if the annual pre-tax internal rate of return on this loan exceeds Leif's hurdle (discount) rate of 20% on investment. Present value factors yielding 20% are approximately:

<u>Year</u>	<u>Factor</u>
1	.8
2	.7
3	.6

Required:

a. As a guide to Leif Company in determining a selling price for Kace, prepare a schedule of the expected annual contribution margin for each of the sales prices proposed for Kace.

b. 1. Compute Leif Company's current pre-tax accounting rate of return on its investment in Sigma Division.

2. Compute Leif Company's expected pre-tax accounting rate of return on its proposed investment in Sigma Division if Baum's two recommendations are implemented.

c. Regarding the possible financing of Cote Corp. by Leif Company, compute the net present value of Leif Company's investment opportunity on the proposed loan to Cote Corp., and state whether the investment would earn Leif a minimum internal rate of return of 20%.

2M85

Number 4 (Estimated time — — 45 to 55 minutes)

Mayne Manufacturing Co. has incurred substantial losses for several years, and has become insolvent. On March 31, 1985, Mayne petitioned the court for protection from creditors, and submitted the following statement of financial position:

Mayne Manufacturing Co.
STATEMENT OF FINANCIAL POSITION
March 31, 1985

	<u>Book value</u>	<u>Liquidation value</u>
<u>Assets:</u>		
Accounts receivable	\$100,000	\$ 50,000
Inventories	90,000	40,000
Plant and equipment	150,000	160,000
Totals	<u>\$340,000</u>	<u>\$250,000</u>
<u>Liabilities and Stockholders' Equity:</u>		
Accounts payable — general creditors	\$600,000	
Common stock outstanding	60,000	
Deficit	<u>(320,000)</u>	
Total	<u>\$340,000</u>	

Mayne's management informed the court that the company has developed a new product, and that a prospective customer is willing to sign a contract for the purchase of 10,000 units of this product during the year ending March 31, 1986, 12,000 units of this product during the year ending March 31, 1987, and 15,000 units of this product during the year ending March 31, 1988, at a price of \$90 per unit. This product can be manufactured using Mayne's present facilities. Monthly production with immediate delivery is expected to be uniform within each year. Receivables are expected to be collected during the calendar month following sales.

Unit production costs of the new product are expected to be as follows:

Direct materials	\$20
Direct labor	30
Variable overhead	10

Fixed costs (excluding depreciation) will amount to \$130,000 per year.

Purchases of direct materials will be paid during the calendar month following purchase. Fixed costs, direct labor, and variable overhead will be paid as incurred. Inventory of direct materials will be equal to 60 days' usage. After the first month of operations, 30 days' usage of direct materials will be ordered each month.

The general creditors have agreed to reduce their total claims to 60% of their March 31, 1985 balances, under the following conditions:

- Existing accounts receivable and inventories are to be liquidated immediately, with the proceeds turned over to the general creditors.
- The balance of reduced accounts payable is to be paid as cash is generated from future operations, but in no event later than March 31, 1987. No interest will be paid on these obligations.

Under this proposed plan, the general creditors would receive \$110,000 more than the current liquidation value of Mayne's assets. The court has engaged you to determine the feasibility of this plan.

Required:

Ignoring any need to borrow and repay short-term funds for working capital purposes, prepare a cash budget for the years ending March 31, 1986 and 1987, showing the cash expected to be available to pay the claims of the general creditors, payments to general creditors, and the cash remaining after payment of claims.

Selected Questions

VIII. Not-for-Profit and Governmental Accounting

2M87

Number 5 (Estimated time — — 40 to 50 minutes)

Esperanza Hospital's post-closing trial balance at December 31, 1986, appears on the tear-out worksheet.

Esperanza, which is a nonprofit hospital, did **not** maintain its books in conformity with the principles of hospital fund accounting. Effective January 1, 1987, Esperanza's board of trustees voted to adjust the December 31, 1986 general ledger balances, and to establish separate funds for the general (unrestricted) funds, the endowment fund, and the plant replacement and expansion fund.

Additional account information:

- Investment in corporate bonds pertains to the amount required to be accumulated under a board policy to invest cash equal to accumulated depreciation until the funds are needed for asset replacement. The \$500,000 balance at December 31, 1986, is less than the full amount required because of errors in computation of building depreciation for past years. Included in the allowance for depreciation is a correctly computed amount of \$90,000 applicable to equipment.

- Endowment fund balance has been credited with the following:

Donor's bequest of cash	\$300,000
Gains on sales of securities	100,000
Interest and dividends earned in 1984, 1985, and 1986	120,000
Total	<u>\$520,000</u>

The terms of the bequest specify that the principal, plus all gains on sales of investments, are to remain fully invested in U.S. government or corporate securities. At December 31, 1986, \$400,000 was invested in U.S. Treasury bills. The bequest further specifies that interest and dividends earned on investments are to be used for payment of current operating expenses.

- Land comprises the following:

Donation of land in 1970, at appraised value	\$ 40,000
Appreciation in fair value of land as determined by independent appraiser in 1980	60,000
Total	<u>\$100,000</u>

- Building comprises the following:

Hospital building completed in January 1947, when operations were started (estimated useful life 50 years), at cost	\$720,000
Installation of elevator in January 1967 (estimated useful life 20 years), at cost	80,000
Total	<u>\$800,000</u>

Required:

Turn to the tear-out worksheet, and enter the adjustments necessary to restate the general ledger account balances properly. Distribute the adjusted balances to establish the separate fund accounts, and complete the worksheet. Formal journal entries are not required, but supporting computations should be referenced to the worksheet adjustments.

2M87
Number 5 (cont.)

Candidate's No. _____
State _____
Question 5 Page _____

Esperanza Hospital
**WORKSHEET TO ADJUST GENERAL LEDGER BALANCES
AND TO ESTABLISH SEPARATE FUNDS**
January 1, 1987

Account	Trial Balance December 31, 1986		Adjustments		General (Unrestricted) Funds		Endowment Fund		Plant Replacement and Expansion Fund	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	60,000									
Investment in U.S. Treasury bills	400,000									
Investment in corporate bonds	500,000									
Interest receivable	10,000									
Accounts receivable	50,000									
Inventory	30,000									
Land	100,000									
Building	800,000									
Equipment	170,000									
Allowance for depreciation		410,000								
Accounts payable		20,000								
Notes payable		70,000								
Endowment fund balance		520,000								
Other fund balances		1,100,000								

Selected Questions

[illegible]

Accounting Practice

2M86

Number 5 (Estimated time — — 40 to 50 minutes)

Listed below are four independent transactions or events that relate to a local government and to a voluntary health and welfare organization:

- [1] \$25,000 was disbursed from the general fund (or its equivalent) for the cash purchase of new equipment.
- [2] An unrestricted cash gift of \$100,000 was received from a donor.
- [3] Listed common stocks with a total carrying value of \$50,000, exclusive of any allowance, were sold by an endowment fund for \$55,000, before any dividends were earned on these stocks. There are no restrictions on the gain.
- [4] \$1,000,000 face amount of general obligation bonds payable were sold at par, with the pro-

ceeds required to be used solely for construction of a new building. This building was completed at a total cost of \$1,000,000, and the total amount of bond issue proceeds was disbursed in connection therewith. Disregard interest capitalization.

Required:

a. For each of the above-listed transactions or events, prepare journal entries, without explanations, specifying the affected funds and account groups, and showing how these transactions or events should be recorded by a local government whose debt is serviced by general tax revenues.

b. For each of the above-listed transactions or events, prepare journal entries, without explanations, specifying the affected funds, and showing how these transactions or events should be recorded by a voluntary health and welfare organization that maintains a separate plant fund.

Selected Questions

2M85

Number 5 (Estimated time — — 40 to 50 minutes)

Following are the adjusted current funds trial balances of Community Association for Handicapped Children, a voluntary health and welfare organization, at June 30, 1984:

Community Association For Handicapped Children
ADJUSTED CURRENT FUNDS TRIAL BALANCES
June 30, 1984

	<i>Unrestricted</i>		<i>Restricted</i>	
	<i>Dr.</i>	<i>Cr.</i>	<i>Dr.</i>	<i>Cr.</i>
Cash	\$ 40,000		\$ 9,000	
Bequest receivable			5,000	
Pledges receivable	12,000			
Accrued interest receivable	1,000			
Investments (at cost, which approximates market)	100,000			
Accounts payable and accrued expenses		\$ 50,000		\$ 1,000
Deferred revenue		2,000		
Allowance for uncollectible pledges		3,000		
Fund balances, July 1, 1983:				
Designated		12,000		
Undesignated		26,000		
Restricted				3,000
Transfers of endowment fund income		20,000		
Contributions		300,000		15,000
Membership dues		25,000		
Program service fees		30,000		
Investment income		10,000		
Deaf children's program	120,000			
Blind children's program	150,000			
Management and general services	45,000		4,000	
Fund-raising services	8,000		1,000	
Provision for uncollectible pledges	2,000			
	<u>\$478,000</u>	<u>\$478,000</u>	<u>\$19,000</u>	<u>\$19,000</u>

Required:

a. Prepare a statement of support, revenue, and expenses and changes in fund balances, separately presenting each current fund, for the year ended June 30, 1984.

b. Prepare a balance sheet separately presenting each current fund as of June 30, 1984.

IX. Federal Taxation — Individuals, Estates, and Trusts

2M87

Number 4 (Estimated time — — 45 to 55 minutes)

In December 1986, John Ford (age 40) died, leaving a wife (Ann, age 35) and a dependent son (Earl, age 3). A 1986 joint return was filed in April 1987 for John and Ann. Ann now consults you, as a CPA, for advice as to how the 1986 Tax Reform Act is expected to affect her 1987 tax status. She furnishes you with the following projections pertaining to her expected cash receipts and expenditures for the year ending December 31, 1987:

Employment as an outside salesperson:

Gross salary and commissions	\$50,000
Ordinary and necessary employee business expenses	
Allowable transportation	4,000
Stationery, postage, telephone	1,000
Payroll taxes	
Federal income tax withheld	9,000
FICA tax withheld	3,132
State income tax withheld	1,800

Employment as part-time teacher:

Gross salary	3,000
Payroll taxes	
Federal income tax withheld	300
FICA tax withheld	215

Other cash expected to be received in 1987:

Bequest under husband's will	25,000
Life insurance proceeds on husband's death	15,000
Dividends from taxable domestic corporations	500
Gross lottery winnings in January 1987	2,000

Security transaction in 1987:

Net proceeds from sale of 500 shares of stock (This stock was inherited from Ann's father, Sam, in 1980; Sam had paid \$2,500 for this stock, which had a fair market value of \$6,000 on the date of Sam's death; Sam's estate did not elect to use the alternate valuation date.)	10,000
--	--------

In addition, John had provided in his will for the establishment of a simple trust, under which all of the trust's income was required to be distributed currently to Ann, as beneficiary of this trust. The entire trust principal was invested in bank certificates of deposit. Trust income is expected to be \$12,000 in 1987. However, Ann wants to draw only \$7,000 of this income in 1987.

During 1987, Ann expects to have the following cash expenditures in addition to those indicated previously:

Food, clothing, household, and miscellaneous personal expenses for both Ann and Earl	\$20,000
Estimated income tax — federal	5,000
Estimated income tax — state	1,200
State inheritance tax on John's taxable estate	2,100
Realty taxes on residence	3,600
City and state sales taxes	1,100
Auto license and registration fees	50
Contribution to church	600
Political contribution	100
Lottery tickets	420
Pari-mutuel gambling	480

Selected Questions

Required:

a. Prepare a schedule listing all items of projected receipts and expenditures that have **no** effect on Ann Ford's 1987 federal taxable income.

b. Prepare a schedule computing Ann Ford's projected 1987 federal taxable income, in the following sequence:

Adjusted gross income
Itemized deductions
Personal exemptions (\$1,900 per exemption)
Taxable income

c. Assume that Ann Ford's projected 1987 federal income tax on her federal taxable income will be \$12,421 before credits and prepayments of tax. Compute the projected balance of tax payable or net overpayment.

2N86

Number 5 (Estimated time — — 40 to 50 minutes)

The following information pertains to Alex and Myra Cole, a married couple filing a joint federal income tax return for the calendar year 1985:

Alex, age 72 — cash received in 1985

Social security benefits	
Gross amount	\$ 9,900
Less voluntary premiums under Medicare Part B	190
Net amount received	<u>9,710</u>
Proceeds of life insurance policy on death of friend	5,000
Proceeds from sales of stock	
Bought in May 1980 — basis \$2,000	3,000
Bought in October 1985 — basis \$900	700
Dividends	
From taxable domestic corporations	500
On life insurance policy (accumulated net premiums not exceeded)	131

Myra, age 60 — cash received in 1985

Salary — employed as actuary		
Gross amount	\$62,000	
Amounts withheld		
Federal income tax	\$10,000	
State income tax	3,349	
FICA taxes	2,792	
United Fund pledge	<u>240</u>	
	<u>16,381</u>	<u>45,619</u>
Total cash received		<u><u>\$64,660</u></u>

Accounting Practice

2N86

Number 5 (cont.)

Cash paid in 1985

Rent, household, and other personal expenses		\$40,000
Estimated 1985 federal income tax		3,000
Business travel away from home overnight		800
Continuing professional education courses required by Society of Actuaries		400
Medical and dental expenses		
Doctors	\$ 3,000	
Dentures	800	
Travel to doctors	100	3,900
Contribution to a national political party		500
Total cash paid		<u>\$48,600</u>

Additional information:

- The 1984 joint federal income tax return showed a tax overpayment of \$900, which was refunded to the Coles in 1985.
- The 1984 joint state income tax return showed a tax overpayment of \$110, which was refunded to the Coles in 1985.
- The Coles itemized their deductions on their 1984 return.
- In March 1985, Alex donated 100 shares of stock of a listed corporation to a recognized charitable organization. Alex's basis for this stock, which was bought in 1960, was \$1,000. Fair market value of this stock on the date of the donation was \$7,000.
- Included in the Coles' personal expenses was \$1,100 for state sales taxes, substantiated by receipts. The Coles elected not to use the optional state sales tax table.
- The Coles supported their son, Ben, who had been disabled since birth, and who lived in the Cole household. Ben had no income. He died in January 1985 at the age of 34.
- In June 1985, Myra received a watch as a gift from her employer, as a token of the employer's appreciation for Myra's efforts in recruiting new clients. This watch had a fair market value of \$1,500. The recruiting of new clients was not part of Myra's prescribed duties.
- In 1980, Alex established a reversionary ("Clifford") trust for the benefit of a destitute friend who lives alone. Trust income amounted to \$2,200 in 1985, which constituted more than 50% of the friend's support for the year. A local bank is trustee.
- Personal exemptions and exemptions for dependents are \$1,040 each.
- The zero bracket amount is \$3,540.

Required:

a. Prepare a detailed schedule computing Alex and Myra Cole's joint taxable income for 1985. Show each appropriate item separately in the schedule, and classify each item properly. Any possible alternative treatment should be resolved in a manner that will minimize 1985 taxable income.

b. Assume that Alex and Myra Cole's 1985 federal income tax on their 1985 joint taxable income is \$12,957 before tax credits and payments. Compute the net amount of tax payable or net overpayment of tax.

Selected Questions

X. Federal Taxation — Corporations, Partnerships, and Exempt Organizations

2M89

Number 4 (Estimated time — 45 to 55 minutes)

The following adjusted accounts appeared in the records of Elm Corp., an accrual basis corporation, for the year ended December 31, 1988. Numbers in brackets refer to the items in *Additional information*.

Revenues and gains

Net sales	\$5,500,000	[1]
Dividends	10,000	[2]
Interest	4,000	[3]
Gain on sale of stock	6,000	[4]
Equity in earnings of Luz Partnership	50,000	[5]
Key-man life insurance proceeds	200,000	[6]
Tax refund	3,000	[7]
Total	<u>5,773,000</u>	

Cost and expenses

Cost of goods sold	3,900,000	[8]
Salaries and wages	571,000	[9]
Doubtful accounts	15,000	[10]
Taxes	100,000	[11]
Interest	20,000	[12]
Contributions	175,000	[13]
Depreciation	90,000	[14]
Other	30,000	[15]
Federal income tax	193,000	[16]
Total	<u>5,094,000</u>	
Net income	<u>\$ 679,000</u>	

Additional information:

- [1] Trade accounts receivable at December 31, 1988 and at December 31, 1987 amounted to \$300,000 and \$180,000, respectively.
- [2] Dividends were declared and paid in 1988 by an unrelated taxable domestic corporation whose securities are traded on a major stock exchange.
- [3] Interest revenue comprises interest on municipal bonds issued in 1982 and purchased by Elm in the open market in 1988.
- [4] Gain on sale of stock arose from the following purchase and sale of stock in an unrelated corporation listed on a major stock exchange:

Bought in 1980	Cost	\$12,000
Sold in 1988	Proceeds of sale	18,000

- [5] Elm owns 50% of Luz Partnership. The other 50% is owned by an unrelated individual. Luz reported the following tax information to Elm:

Elm's share of:

Partnership ordinary income	\$63,000
Net long-term capital loss	(13,000)

- [6] Elm owned the key-man life insurance policy, paid the premiums, and was the direct beneficiary. The proceeds were collected on the death of Elm's controller.
- [7] The tax refund arose from Elm's overpayment of federal income tax on the 1986 return.
- [8] Cost of goods sold relates to Elm's net sales.
- [9] Salaries and wages includes officers' compensation of \$125,000.
- [10] Doubtful accounts expense represents an addition to Elm's allowance for doubtful accounts based on an aging schedule whereby Elm "reserves" all accounts receivable over 120 days for book purposes. The balance in Elm's allowance for doubtful accounts was \$142,000 at December 31, 1988. Actual bad debts written off in 1988 amounted to \$9,000. Elm's allowance for doubtful accounts at December 31, 1986 (at the beginning of the first year of the tax law change) was \$120,000.
- [11] Taxes comprise payroll taxes and property taxes.
- [12] Interest expense resulted from borrowing for working capital purposes.
- [13] Contributions were all paid in 1988 to State University, specifically designated for the purchase of computers.
- [14] Elm has always used straight-line depreciation for both book and tax purposes.
- [15] Other expenses include premiums of \$12,000 on the key-man life insurance policy covering the controller.
- [16] Federal income tax is the amount estimated and accrued before preparation of the return.

Required:

Prepare a schedule of taxable income as it should appear on Elm's 1988 federal income tax return. Show all items required to be included in the return. Assume that the alternative minimum tax is less than the regular tax. Any possible optional treatment should be resolved in a manner that will minimize Elm's 1988 taxable income.

Accounting Practice

2M86

Number 4 (Estimated — — 45 to 55 minutes)

The following adjusted revenue and expense accounts appeared in the accounting records of Wolf, Inc., an accrual basis taxpayer, for the year ended December 31, 1985:

Revenues

Net sales	\$3,000,000	[1]
Equity in earnings of F & W Partnership	60,000	[2]
Dividends	8,000	[3]
Interest	18,000	[4]
Gains on sale of stock	5,000	[5]
Key-man life insurance proceeds	100,000	[6]
Total	<u>3,191,000</u>	

Costs and expenses

Cost of goods sold	2,000,000	[7]
Salaries and wages	500,000	
Doubtful accounts	13,000	[8]
Taxes, other than federal income	62,000	[9]
Interest	12,000	[10]
Contributions	50,000	[11]
Depreciation	60,000	[12]
Other	40,000	[13]
Federal income taxes	120,000	[14]
Total	<u>2,857,000</u>	

Net income \$ 334,000

The following additional information is provided:

- [1] Trade accounts receivable at December 31, 1984, and at December 31, 1985, amounted to \$200,000 and \$250,000, respectively.
- [2] Wolf, Inc. owns 60% of F & W Partnership. The other 40% of F & W is owned by an unrelated individual. F & W reported the following tax information to Wolf, Inc.:

Wolf, Inc.'s share of:

Partnership ordinary income	\$58,000
Dividends qualifying for exclusion	10,000
Net long-term capital gain (loss)	<u>(8,000)</u>
Equity in earnings	<u>\$60,000</u>

The \$10,000 dividends were from an unrelated domestic corporation, Jel Corp., whose securities are traded on a major stock exchange.

Selected Questions

- [3] The \$8,000 dividends were from Meg, Inc., an unrelated taxable domestic corporation, whose securities are traded on a major stock exchange.
- [4] Interest revenue consists of interest on:
- | | |
|-----------------|----------|
| Corporate bonds | \$15,000 |
| Municipal bonds | 3,000 |
- [5] Gains on sale of stock consist of stock of the following unrelated corporations:
- | | |
|---|---------|
| Ral Corp. (bought in May 1985; sold in June 1985) | \$1,000 |
| Blu, Inc. (bought in November 1984; sold in September 1985) | 4,000 |
- [6] Wolf, Inc. owned the key-man life insurance policy, paid the premiums, and was the direct beneficiary. The proceeds were collected on the death of the corporation's treasurer.
- [7] Accounts payable for merchandise at December 31, 1984, and at December 31, 1985, amounted to \$75,000 and \$100,000, respectively.
- [8] Doubtful accounts expense represents a reasonable addition to Wolf, Inc.'s allowance for doubtful accounts, under the method consistently used. Actual accounts written off in 1985 amounted to \$4,000.
- [9] Taxes, other than federal income, consist of:
- | | |
|-----------------------------------|----------|
| Payroll taxes | \$40,000 |
| Property taxes | 20,000 |
| Penalty for late payment of taxes | 2,000 |
- [10] Interest expense consists of: \$11,000 interest on funds borrowed for working capital, and \$1,000 interest on funds borrowed to buy the municipal bonds.
- [11] Contributions were all paid in 1985 to State University, specifically designated for the purchase of laboratory equipment.
- [12] Depreciation per books is straight-line. For tax purposes, depreciation amounted to \$85,000. The investment tax credit amounted to \$3,000.
- [13] Other expenses include premiums of \$5,000 on the key-man life insurance policy covering the treasurer, who died in December 1985.
- [14] Federal income tax paid in 1985 amounted to \$105,000. The difference between the income tax provision and income tax paid is the result of interperiod tax allocation.

Required:

Complete the tear-out worksheet by making the necessary adjustments to convert Wolf, Inc.'s 1985 book income to federal taxable income.

Any possible alternative treatment should be resolved in a manner that will minimize 1985 taxable income for Wolf, Inc.

2M86
Number 4 (cont.)

Candidate's No. _____
State _____
Question No. 4 Page _____

Wolf, Inc.
WORKSHEET TO CONVERT BOOK INCOME TO TAXABLE INCOME
For the Year Ended December 31, 1985

	<i>Per books and GAAP</i>	<i>Increases</i>	<i>Decreases</i>	<i>Per tax return</i>
<u>Revenues</u>				
Net sales	3,000,000			
Equity in earnings of F & W Partnership	60,000			
Dividends	8,000			
Interest	18,000			
Gains on sale of stock	5,000			
Key-man life insurance proceeds	100,000			
Totals	3,191,000			
<u>Costs and expenses</u>				
Cost of goods sold	2,000,000			
Salaries and wages	500,000			
Doubtful accounts	13,000			
Taxes, other than federal income	62,000			
Interest	12,000			
Contributions	50,000			
Depreciation	60,000			
Other	40,000			
Federal income taxes	120,000			
Totals	2,857,000			
Net income	334,000			

PROBLEMS — UNOFFICIAL ANSWERS

I. Presentation of Financial Statements or Worksheets

A. Balance Sheet

1M87

Answer 5 (10 points)

a.

Computation of Cox's Goodwill Implicit in the Terms of the Common Stock Issuance

Cash paid by Rice for 1,000 shares		\$ 86,000
Contribution by Cox		
Current fair value of assets		
Cash	\$ 16,500	
Accounts receivable	20,200	
Merchandise inventory	45,000	
Prepaid insurance	1,900	
Equipment	40,000	
	<u>123,600</u>	
Current fair value of liabilities assumed		
Accounts payable	30,500	
Note payable	10,000	
Loan payable, delivery van	3,500	
Interest payable	600	
Payroll taxes withheld and accrued	2,100	
	<u>46,700</u>	
Net contribution by Cox for 1,000 shares		<u>76,900</u>
Cox's goodwill		<u><u>\$ 9,100</u></u>

b.

Cox Stationers, Inc. BALANCE SHEET January 1, 1987

	<u>Assets</u>	
<u>Current Assets:</u>		
Cash		\$102,500 [1]
Accounts	\$23,500	
Less allowance for doubtful accounts	<u>3,300</u>	20,200
Merchandise inventory		45,000
Prepaid insurance		<u>1,900 [2]</u>
Total current assets		169,600
Equipment		40,000
Goodwill		<u>9,100</u>
Total assets		<u><u>\$218,700</u></u>

1M87

Answer 5 (cont.)

Liabilities and Stockholders' EquityCurrent Liabilities

Note payable, bank	\$ 10,000
Loan payable, delivery van	3,500
Accounts payable	30,500
Accrued interest	600 [3]
Payroll taxes withheld and accrued	2,100
Total current liabilities	<u>46,700</u>

Stockholders' Equity:

Common stock, \$50 par; authorized 7,500 shares; issued and outstanding 2,000 shares	100,000
Additional paid-in capital	72,000 [4]
Total stockholders' equity	<u>172,000</u>
Total liabilities and stockholders' equity	<u>\$218,700</u>

Explanations of Amounts:

[1] Cash	
Balance, 12/31/86	\$ 16,500
1/1/87, sale of common stock to Rice	86,000
Balance, 1/1/87	<u>\$102,500</u>
[2] Prepaid insurance	
Paid, 7/1/86	\$ 3,800
Prepaid, 12/31/86 ($\times \frac{1}{2}$)	<u>\$ 1,900</u>
[3] Accrued interest on note payable	
Annual interest (\$10,000 \times 12%)	\$ 1,200
July 1 — December 31, 1986 ($\times \frac{1}{2}$)	<u>\$ 600</u>
[4] Additional paid-in capital	
Total assets	\$218,700
Deduct liabilities	46,700
Total stockholders' equity	172,000
Deduct common stock (2,000 shares \times \$50)	100,000
Additional paid-in capital	<u>\$ 72,000</u>

1M86

Answer 5 (10 points)

Rand, Inc.
**WORKSHEET FOR BALANCE SHEET
 AND INCOME STATEMENT**
 December 31, 1985

	Balance per books	Adjustments		Corrected balance
		Debit	Credit	
Balance sheet				
Assets:	Dr. (Cr.)			Dr. (Cr.)
Cash	\$ 275,000			\$ 275,000
Marketable securities, at cost	78,000			78,000
Allowance to reduce marketable securities to market	—		[1] \$ 11,000	(11,000)
Accounts receivable	487,000			487,000
Allowance for doubtful accounts	(50,000)	[2] \$ 15,800		(34,200)
Inventories	425,000		[3] 17,500	407,500
Property and equipment	310,000	[4] 30,000	[5] 18,500	321,500
Accumulated depreciation	(150,000)	[5] 21,000	[4] 12,000	(141,000)
	<u>\$ 1,375,000</u>	<u>\$ 66,800</u>	<u>\$ 59,000</u>	<u>\$ 1,382,800</u>
Liabilities & stockholders' equity:	(Cr.)			(Cr.)
Accounts payable & accrued liabilities	\$ 420,000			\$ 420,000
Estimated liability from lawsuit	100,000	[7] \$100,000		—
Common stock	260,000			260,000
Additional paid-in capital	130,000			130,000
Retained earnings				
Balance, 1/1/85	254,000	[3] 12,000	[4] \$ 24,000 [6] 25,000	291,000
Net income for 1985	211,000	47,500	118,300	281,800
	<u>\$ 1,375,000</u>	<u>\$159,500</u>	<u>\$167,300</u>	<u>\$ 1,382,800</u>
Income statement				
	Dr. (Cr.)			Dr. (Cr.)
Net sales	\$(1,580,000)			\$(1,580,000)
Cost of sales	755,000	[3] \$ 5,500		760,500
Selling & administrative expenses	485,000	[6] 25,000	[2] \$ 15,800	494,200
Depreciation expense	29,000	[4] 6,000		35,000
Other income			[5] 2,500	(2,500)
Unrealized loss on marketable securities		[1] 11,000		11,000
Estimated loss from lawsuit	100,000		[7] 100,000	—
Net income	<u>\$ (211,000)</u>	<u>\$ 47,500</u>	<u>\$118,300</u>	<u>\$ (281,800)</u>

1M86

Answer 5 (cont.)

Explanations of Corrections

[1]	Decline in market valuation of marketable securities at 12/31/85	
	At cost	\$78,000
	Market valuation	<u>67,000</u>
	Unrealized loss on marketable securities [Dr.]	<u>\$11,000</u>
	Allowance to reduce marketable securities to market [Cr.]	<u>\$11,000</u>
[2]	Decline in doubtful accounts expense rate effective 1/1/85	
	Doubtful accounts expense charge at 3% of net sales for 1985 $[3\% \times \$1,580,000]$	\$47,400
	Doubtful accounts expense stated at 2% of net sales for 1985 $[2\% \times \$1,580,000]$	<u>31,600</u>
	Allowance for doubtful accounts [Dr.]	<u>\$15,800</u>
	Selling & adm. expense — Doubtful accounts expense [Cr.]	<u>\$15,800</u>
[3]	Inventories overstated at 12/31/84 and 12/31/85	
	Retained earnings [overstatement at 12/31/84] [Dr.]	\$12,000
	Cost of sales for 1985 $[\$17,500 - \$12,000]$ [Dr.]	<u>5,500</u>
	Inventories [overstatement at 12/31/85] [Cr.]	<u>\$17,500</u>
[4]	Incorrect recording of equipment purchased 1/1/84	
	Property and equipment [Dr.]	\$30,000
	Depreciation expense — 1985 $[20\% \times \$30,000]$ [Dr.]	<u>6,000</u>
		<u>\$36,000</u>
	Accumulated depreciation $[2 \times \$6,000]$ [Cr.]	\$12,000
	Retained earnings (understatement at 12/31/84) $[\$30,000 - \$6,000]$ [Cr.]	<u>24,000</u>
		<u>\$36,000</u>
[5]	Incorrect recording of fully depreciated equipment sold as scrap 7/1/85	
	Accumulated depreciation [Dr.]	\$21,000
	Property and equipment $[\$21,000 - \$2,500]$ [Cr.]	<u>18,500</u>
	Other income [Cr.]	<u>\$ 2,500</u>
[6]	Incorrect recording of sales catalogs as expense in 1984	
	Selling & adm. exp. — Advertising & promotion [Dr.]	<u>\$25,000</u>
	Retained earnings (understatement at 12/31/84) [Cr.]	<u>\$25,000</u>
[7]	Reversal of liability from lawsuit — No probable loss 12/31/85	
	Estimated liability from lawsuit [Dr.]	\$100,000
	Estimated loss from lawsuit [Cr.]	<u>\$100,000</u>

Unofficial Answers

B. Income Statement

In November 1987, the FASB issued *Statement of Financial Accounting Standards No. 96*, "Accounting for Income Taxes." Income tax calculations in this section of *Selected Questions & Unofficial Answers* are based on *APB Opinion No. 11*, "Accounting for Income Taxes," for all examination questions prior to May 1989. All subsequent examination questions and unofficial answers relating to accounting for income taxes are and will be based on SFAS No. 96.

1M89

Answer 4 (10 points)

a.

Pitt Corp.
INCOME STATEMENT
For the Year Ended December 31, 1988

Net sales			\$6,250,000
Cost of sales			<u>3,750,000</u>
Gross profit			2,500,000
Selling and administrative expenses			<u>1,212,500</u>
Operating income			1,287,500
Other expenses			
Interest expense			<u>122,500</u>
Income before unusual or infrequent items and income tax			1,165,000
Unusual or infrequent items			
Loss on disposition of plant assets	\$(225,000)		
Gain on sale of long-term investments	<u>130,000</u>		<u>(95,000)</u>
Income before income tax and extraordinary item			1,070,000
Income tax			
Current	342,000	[1]	
Deferred	<u>27,000</u>	<u>[2]</u>	<u>369,000</u>
Income before extraordinary item			701,000
Extraordinary item — loss from earthquake (net of applicable income tax benefit of \$142,500)			<u>332,500</u> [3]
Net income			<u>\$ 368,500</u>
Earnings per share			
Income before extraordinary item			\$2 .98 [4]
Extraordinary loss			<u>(1.41)</u> *
Net income			<u>\$1.57</u> [5]

*Optional

1M89

Answer 4 (cont.)

b.

Pitt Corp.
RECONCILIATION OF NET INCOME TO
TAXABLE INCOME PER TAX RETURN
For the Year Ended December 31, 1988

Net income	
Add: Income tax on continuing operations	\$368,500
Officers' life insurance expense	369,000
	<u>70,000</u>
	807,500
Deduct: Income tax benefit — extraordinary loss	<u>142,500</u>
Taxable income per tax return	<u><u>\$665,000</u></u>

Explanation of amounts

[1] Total income tax excluding extraordinary item for 1988	
Income before income tax and extraordinary item	\$1,070,000
Officers' life insurance expense	<u>70,000</u>
Income subject to tax	1,140,000
Income tax rate	<u>× 30%</u>
Income tax excluding extraordinary item	<u><u>\$ 342,000</u></u>
[2] Deferred income tax for 1988	
Excess of book basis over tax basis in depreciable assets (Expected to reverse equally over next 5 years)	<u>\$90,000</u>
Deferred income tax liability, 12/31/88 ($\$90,000 \times 30\%$)	<u>\$27,000</u>
Less beginning balance, 1/1/88	<u>-0-</u>
Net change in deferred tax liability for 1988	<u><u>\$27,000</u></u>
[3] Extraordinary item — Loss from earthquake damage (net of income tax) for 1988	
Loss from earthquake damage	\$475,000
Income tax benefit ($30\% \times \$475,000$)	<u>142,500</u>
Net of income tax effect	<u><u>\$332,500</u></u>
[4] Earnings per share of income before extraordinary item for 1988	
Income before extraordinary item	<u>\$701,000</u>
Weighted average number of shares outstanding for 1988 [$200,000 + 20,000 + 15,000 (\frac{1}{2} \times 30,000)$]	<u>235,000</u>
Earnings per share ($\$701,000 \div 235,000$)	<u><u>\$2.98</u></u>
[5] Earnings per share on net income for 1988	
Net income	<u>\$368,500</u>
Weighted average number of shares	<u>235,000</u>
Earnings per share ($\$368,500 \div 235,000$)	<u><u>\$1.57</u></u>

Unofficial Answers

2M88

Answer 4 (10 points)

Arlon Corporation
INCOME STATEMENT
For the Year Ended December 31, 1987

Sales		\$500,000
Cost of sales		<u>310,000</u>
Gross margin		190,000
Administrative expenses		<u>103,000</u>
Operating income		87,000
Other income and expense		
Life insurance policy proceeds	\$10,000	
Interest expense	<u>(10,500)</u>	<u>(500)</u>
Income from continuing operations before income tax		86,500
Income tax		
Current	\$14,410	
Deferred	<u>2,420</u>	<u>16,830</u>
Income from continuing operations		69,670
Discontinued operations		
Income from discontinued Mem Division, less applicable income tax of \$7,260	\$25,740	
Loss on disposal of Mem Division, less applicable income tax saving of \$2,750	<u>(9,750)</u>	<u>15,990</u>
Income before extraordinary item		85,660
Extraordinary item — gain on acquisition of bonds payable, less applicable income tax of \$2,860		<u>10,140</u>
Net income		<u>\$ 95,800</u>
Earnings per share		
From continuing operations		\$.070
From discontinued operations		<u>.016</u>
Total before extraordinary item		.086
From extraordinary item		<u>.010</u>
Net income		<u><u>\$.096</u></u>

2M88

Answer 4 (cont.)

COMPUTATION OF CURRENT AND DEFERRED INCOME TAXES

Income from continuing operations before income tax		\$86,500
Less permanent difference — proceeds of life insurance policy		<u>10,000</u>
Balance subject to tax		76,500
Income tax rate		<u>× 22%</u>
Income tax on continuing operations		<u><u>\$16,830</u></u>

Current

Income per income tax return			\$99,000
Less intraperiod tax allocations			
Discontinued operations			
Income before income tax	\$33,000		
Loss on disposal	<u>(12,500)</u>	\$20,500	
Extraordinary item			
Gain on acquisition of bonds payable		<u>13,000</u>	<u>33,500</u>
Taxable income on continuing operations			65,500
Income tax rate			<u>× 22%</u>
Income tax — current			\$14,410

Deferred

Depreciation per income tax return	\$46,000		
Depreciation per financial statements	<u>30,000</u>		
Excess of depreciation per income tax return over depreciation per financial statements	16,000		
Rental revenue received in advance	<u>(5,000)</u>		
Net timing differences			11,000
Income tax rate			<u>× 22%</u>
Income tax — deferred			<u>2,420</u>
Income tax on continuing operations			<u><u>\$16,830</u></u>

COMPUTATION OF INCOME FROM DISCONTINUED OPERATIONS

*For the Six Months Ended June 30, 1987
(Date of Discontinuance)*

Sales	\$100,000
Cost of sales	<u>45,000</u>
Gross margin	55,000
Administrative expenses	<u>15,000</u>
Operating income	40,000
Interest expense	<u>7,000</u>
Income before income tax	33,000
Income tax (at 22%)	<u>7,260</u>
Net income	<u><u>\$ 25,740</u></u>

Unofficial Answers

1N86

Answer 5 (10 points)

Garr Corporation
INCOME STATEMENT
For the Year Ended December 31, 1985

Net sales			\$10,750,000	
Cost of sales			<u>5,920,000</u>	
Gross profit			4,830,000	
Selling and administrative expenses			<u>2,600,000</u>	
Operating income			2,230,000	
Other income				
Interest income			<u>65,000</u>	
Income before unusual item and income tax			2,295,000	
Unusual item				
Gain on litigation settlement			<u>200,000</u>	
Income from continuing operations before income tax			2,495,000	
Income tax				
Current	\$928,000	[3]		
Deferred	<u>70,000</u>	<u>[2]</u>	<u>998,000</u>	[1]
Income from continuing operations			1,497,000	
Discontinued operations				
Operating loss from discontinued				
Plastics Division (less applicable				
income tax saving of \$44,000)	(66,000)	[4]		
Gain on disposal of Plastics Division				
(less applicable income tax of \$60,000)	<u>90,000</u>	<u>[5]</u>	<u>24,000</u>	
Income before cumulative effect of a change				
in accounting principle			1,521,000	
Cumulative effect on prior years of changing				
to a different depreciation method (less				
applicable deferred income tax of \$140,000)			<u>(210,000)</u>	[6]
Net income			<u><u>\$1,311,000</u></u>	
Earnings per share				
Income from continuing operations			\$6.51	[7]
Discontinued operations			0.10	[8]
Cumulative effect on prior years of changing to				
a different depreciation method			<u>(0.91)</u>	[9]
Net income			<u><u>\$5.70</u></u>	[10]

Explanations of Amounts:

[1] Total income tax for 1985 excluding discontinued operations and cumulative effect of accounting change	
Income from continuing operations before income tax	\$2,495,000
Income tax rate	<u>× 40%</u>
Income tax excluding discontinued operations and cumulative effect of accounting change	<u><u>\$ 998,000</u></u>

Accounting Practice

1N86

Answer 5 (cont.)

[2] Deferred income tax for 1985		
Depreciation per tax return		\$ 750,000
Less depreciation per books		<u>575,000</u>
Timing difference		175,000
Income tax rate		× 40%
Deferred income tax		<u>\$ 70,000</u>
[3] Current income tax for 1985 excluding discontinued operations and cumulative effect of accounting change		
Income tax excluding discontinued operations		\$ 998,000
Less deferred income tax		<u>70,000</u>
Current income tax		<u>\$ 928,000</u>
[4] Discontinued operations — Operating loss from Plastics Division		
Sales		\$2,200,000
Cost of sales	\$1,650,000	
Selling and administrative expenses	<u>660,000</u>	<u>2,310,000</u>
Loss		(110,000)
Income tax saving (40% × \$110,000)		<u>44,000</u>
Net of income tax		<u>\$ (66,000)</u>
[5] Discontinued operations — Gain on disposal of Plastics Division		
Gain on disposal		\$ 150,000
Income tax (40% × \$150,000)		<u>60,000</u>
Net of income tax		<u>\$ 90,000</u>
[6] Cumulative effect of changing to a different depreciation method		
Depreciation adjustment — accounting change		\$ 350,000
Reduction in deferred income tax (\$350,000 × 40%)		<u>140,000</u>
Net of income tax		<u>\$ 210,000</u>
[7] Earnings per share — Income from continuing operations		
Income from continuing operations		<u>\$1,497,000</u>
Weighted average number of shares outstanding for 1985 (200,000 + 30,000)		<u>230,000</u>
Earnings per share (\$1,497,000 ÷ 230,000)		<u>\$6.51</u>
[8] Earnings per share — Discontinued operations		
Discontinued operations		<u>\$ 24,000</u>
Weighted average number of shares		<u>230,000</u>
Earnings per share (\$24,000 ÷ 230,000)		<u>\$0.10</u>
[9] Earnings per share — Cumulative effect on prior years of changing to a different depreciation method		
Cumulative effect		<u>\$ (210,000)</u>
Weighted average number of shares		<u>230,000</u>
Earnings per share		<u>\$ (0.91)</u>

Unofficial Answers

[10] Earnings per share — Net income	
Net income	<u>\$1,311,000</u>
Weighted average number of shares	<u>230,000</u>
Earnings per share	<u>\$5.70</u>

1M85

Answer 5 (10 points)

a.

Glenn Corporation
INCOME STATEMENT
For the Year Ended December 31, 1984

Net sales		\$ 12,500,000
Cost of sales		<u>7,500,000</u>
Gross profit		5,000,000
Selling and administrative expenses		<u>2,425,000</u>
Operating income		2,575,000
Interest expense		<u>245,000</u>
Income before unusual or infrequent items and income tax		2,330,000
Unusual or infrequent items		
Loss on litigation settlement	\$(450,000)	
Gain on sale of long-term investments	<u>260,000</u>	<u>(190,000)</u>
Income before income tax and extraordinary item		2,140,000
Income tax		
Current	840,000 [3]	
Deferred	<u>72,000 [2]</u>	<u>912,000 [1]</u>
Income before extraordinary item		1,228,000
Extraordinary item — loss due to earthquake (net of applicable income tax saving of \$380,000)		<u>570,000 [4]</u>
Net income		<u>\$ 658,000</u>
Earnings per share		
Income before extraordinary item		\$5.23 [5]
Extraordinary loss		<u>(2.43) *</u>
Net income		<u>\$2.80 [6]</u>

*Optional

b.

Glenn Corporation
**RECONCILIATION OF NET INCOME TO
TAXABLE INCOME PER TAX RETURN**
For the Year Ended December 31, 1984

Net income		\$ 658,000
Add: Income tax on income before extraordinary item		912,000
Permanent difference — premiums on officers' life insurance		<u>140,000</u>
		1,710,000
Deduct: Income tax savings — extraordinary loss	\$380,000	
Timing difference — depreciation	<u>180,000</u>	<u>560,000</u>
Taxable income per tax return		<u>\$1,150,000</u>

Accounting Practice

1M85

Answer 5 (cont.)

Explanations of Amounts

[1] Total income tax excluding extraordinary item for 1984	
Income before income tax and extraordinary item	\$2,140,000
Add permanent difference — premiums on officers' life insurance	<u>140,000</u>
Income subject to tax	2,280,000
Income tax rate	<u>× 40%</u>
Income tax excluding extraordinary item	<u>\$ 912,000</u>
[2] Deferred income tax for 1984	
Depreciation per tax return	\$760,000
Less depreciation per books	<u>580,000</u>
Timing difference	180,000
Income tax rate	<u>× 40%</u>
Deferred income tax	<u>\$ 72,000</u>
[3] Current income tax excluding extraordinary item for 1984	
Income tax excluding extraordinary item for 1984	\$912,000
Deduct deferred income tax	<u>72,000</u>
Current income tax	<u>\$840,000</u>
[4] Extraordinary item — loss due to earthquake damage (net of income tax) for 1984	
Loss due to earthquake damage	\$950,000
Income tax saving (40% × \$950,000)	<u>380,000</u>
Net of income tax effect	<u>\$570,000</u>
[5] Earnings per share on income before extraordinary item for 1984	
Income before extraordinary item	\$1,228,000
Weighted average number of shares outstanding for 1984 [200,000 + 20,000 + 15,000 (½ × 30,000)]	÷ 235,000
Earnings per share	<u>\$5.23</u>
[6] Earnings per share on net income for 1984	
Net income	\$658,000
Weighted average number of shares	÷ 235,000
Earnings per share	<u>\$2.80</u>

C. Statement of Cash Flows

In November 1987, the FASB issued *Statement of Financial Accounting Standards No. 95*, "Statement of Cash Flows." Accordingly, all previous examination questions and unofficial answers pertaining to "Statement of Changes in Financial Position," covered by *APB Opinion No. 19, Reporting Changes in Financial Position*, have been deleted.

Unofficial Answers

E. Consolidated Financial Statements or Worksheets

1N88
Answer 5 (10 points)

Candidate's No. _____
State _____
Question No. 5 Page _____

a.

Peel, Inc. and Subsidiary
CONSOLIDATED BALANCE SHEET WORKSHEET
December 31, 1987

	<i>Peel, Inc.</i>	<i>Stagg, Inc.</i>	<i>Adjustments & Eliminations</i>		<i>Consolidated Balance</i>
			<i>Debit</i>	<i>Credit</i>	
<i>Assets:</i>					
Cash	\$ 925,000	\$ 300,000			\$1,225,000
Accounts and other receivables	2,140,000	835,000		[3] \$ 8,000	2,247,000
				[4] 720,000	
Inventories	2,310,000	1,045,000		[5] 90,000	3,265,000
Land	600,000	330,000			930,000
Depreciable assets, net	4,525,000	1,980,000			6,505,000
Investment in Stagg, Inc.	2,430,000			[1] 2,430,000	
Long-term investments and other assets	865,000	385,000		[2] 320,000	930,000
	\$13,795,000	\$4,875,000			\$15,102,000
<i>Liabilities and stockholders' equity:</i>					
Accounts payable and other current liabilities	\$2,465,000	\$1,145,000	[3] \$ 8,000		\$ 2,882,000
			[4] 720,000		
Long-term debt	1,900,000	1,300,000	[2] 320,000		2,880,000
Common stock, \$25 par value	3,200,000	1,000,000	[1] 1,000,000		3,200,000
Additional paid-in capital	1,850,000	190,000	[1] 190,000		1,850,000
Retained earnings	4,380,000	1,240,000	[1] 1,240,000		4,290,000
			[5] 90,000		
	\$13,795,000	\$4,875,000	\$3,568,000	\$3,568,000	\$15,102,000

1N88

Answer 5 (cont.)

b. *Peel, Inc. and Subsidiary*
CONSOLIDATED STATEMENT OF
RETAINED EARNINGS
For the Year Ended December 31, 1987

Balance, December 31, 1986:	
As originally reported	\$2,506,000
Adjustment for pooling of interests with Stagg, Inc.	<u>820,000</u>
As restated	3,326,000
Net income	1,380,000 [6]
	<u>4,706,000</u>
Deduct cash dividends paid:	
By Stagg, Inc., prior to combination	160,000 [7]
By Peel, Inc., after the combination	<u>256,000</u>
	<u>416,000</u>
Balance, December 31, 1987	<u><u>\$4,290,000</u></u>

Explanations of Worksheet Entries & Other Amounts

- [1] To eliminate the reciprocal elements in investment and equity accounts.
- [2] To eliminate Peel's investment in Stagg's bonds.
- [3] To eliminate Peel's intercompany accrued interest receivable on its investment in Stagg's bonds for the period 10/1 — 12/31/87. ($\$320,000 \times 10\% \times \frac{1}{4} = \$8,000$)
- [4] To eliminate Peel's intercompany balance for merchandise owed by Stagg.
- [5] To eliminate intercompany profit in ending inventory of Stagg. ($\$180,000 \times \frac{1}{2} = \$90,000$)
- [6] Consolidated net income for 1987
- | | |
|-------------|--------------------|
| Peel, Inc. | \$ 890,000 |
| Stagg, Inc. | <u>580,000</u> |
| | <u>\$1,470,000</u> |
- Deduct intercompany profit in inventory
- | | |
|--|---------------------------|
| | 90,000 |
| | <u><u>\$1,380,000</u></u> |
- [5]
- [7] Dividend paid 6/15/87
[40,000 shares \times \$4]
- | | |
|--|--------------------------|
| | <u><u>\$ 160,000</u></u> |
|--|--------------------------|

Unofficial Answers

2N87

Answer 5 (10 points)

Pym Corp. and Subsidiary
CONSOLIDATED BALANCE SHEET WORKSHEET
December 31, 1986

	<i>Pym Corp.</i>	<i>Sy Corp.</i>	<i>Adjustments & Eliminations</i>		<i>Consolidated</i>
			<i>Debit</i>	<i>Credit</i>	
<i>Assets</i>					
Cash	75,000	15,000			90,000
Accounts & other current receivables	410,000	120,000	[b] 900	[f] 900 [g] 5,000	335,000
				[h] 100,000 [j] 90,000	
Merchandise inventory	920,000	670,000		[i] 3,000	1,587,000
Plant and equipment (net)	1,000,000	400,000			1,400,000
Investment in Sy Corp.	1,200,000		[a] 90,900	[b] 900 [c] 480,000	
				[e] 810,000	
Goodwill			[c] 480,000	[d] 48,000	432,000
Totals	3,605,000	1,205,000			3,844,000
<i>Liabilities and Stockholders' Equity</i>					
Accounts payable and other current liabilities	140,000	305,000	[f] 900 [g] 5,000		249,100
			[h] 100,000 [j] 90,000		
Common stock (\$10 par)	500,000	200,000	[e] 200,000		500,000
Retained earnings	2,965,000	700,000	[d] 48,000 [e] 700,000	[a] 90,900	3,004,900
			[i] 3,000		
Minority interest, 10%				[e] 90,000	90,000
Totals	3,605,000	1,205,000	1,718,700	1,718,700	3,844,000

2N87

Answer 5 (cont.)

Explanations of Worksheet Adjustments and Eliminations

[a] To record net income of Sy Corp. accruing to Pym Corp.	
Sy Corp.'s retained earnings at 12/31/86	\$700,000
Sy Corp.'s retained earnings at 1/1/86	<u>600,000</u>
Increase in retained earnings after dividend declaration	100,000
Add dividend declaration	<u>1,000</u>
Sy Corp.'s net income for the year ended 12/31/86	101,000
Pym Corp.'s share, 90%	<u>\$ 90,900</u>
[b] To record Pym Corp.'s share of dividend declared by Sy Corp.	
90% of \$1,000	<u>\$900</u>
[c] To record goodwill	
Purchase price of 90% of Sy Corp.'s common stock	\$1,200,000
Sy Corp.'s book value at 1/1/86	
Common stock	\$200,000
Retained earnings	<u>600,000</u>
Total	<u>\$800,000</u>
Pym Corp.'s share, 90%	720,000
Goodwill	<u>\$ 480,000</u>
[d] To record amortization of goodwill	
10% of \$480,000	<u>\$48,000</u>
[e] To eliminate 90% of Sy Corp.'s book value and record minority interest	
Common stock	\$200,000
Retained earnings at 12/31/86	<u>700,000</u>
Total	<u>\$900,000</u>
Pym Corp.'s share, 90%	\$810,000
Minority interest, 10%	<u>90,000</u>
Total	<u>\$900,000</u>
[f] To eliminate intercompany dividend receivable and payable	
90% of \$1,000	<u>\$900</u>
[g] To eliminate intercompany accrued interest	
\$100,000 @ 10% × ½ year	<u>\$5,000</u>
[h] To eliminate intercompany loan	
	<u>\$100,000</u>
[i] To eliminate intercompany profit in Sy Corp.'s 12/31 inventory	
Sales from Pym Corp. to Sy Corp.	\$300,000
5% remaining in Sy Corp.'s 12/31 inventory	<u>15,000</u>
Multiply by 20% (60,000/300,000)	<u>\$ 3,000</u>
[j] To eliminate intercompany trade accounts receivable and payable	
	<u>\$90,000</u>

Unofficial Answers

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

A. Cash, Marketable Securities, and Investments

1M89

Answer 5 (10 points)

a.

Poe Corp.
**SCHEDULE OF CURRENT MARKETABLE
EQUITY SECURITIES**
December 31, 1988

	<u>Number of shares</u>	<u>Cost</u>	<u>Market price per share</u>	<u>Market value</u>	<u>Unrealized gain or (loss)</u>
Axe — preferred	500	\$ 20,000	\$56	\$ 28,000	\$ 8,000
Axe — common	1,500	20,000	20	30,000	10,000
Purl — common	3,500	35,000	11	38,500	3,500
Day — common	1,700	42,500	22	37,400	(5,100)
		<u>\$117,500</u>		<u>\$133,900</u>	<u>\$16,400</u>
Valuation allowance [1]		<u>-0-</u>			
Carried at cost		<u>\$117,500</u>			

b.

Poe Corp.
**SCHEDULE OF NONCURRENT MARKETABLE
EQUITY SECURITIES**
December 31, 1988

Scott Corp. — 100,000 shares of common stock:

Cost:				\$1,700,000
Acquisition price				
Increase in equity during 1988:				
Equity in Scott's income			\$360,000	
Less:				
Amortization of excess of cost over underlying equity	\$ 7,500	[2]		
Dividends received	<u>200,000</u>		<u>207,500</u>	
Net increase in equity				<u>152,500</u>
Carrying amount of Poe Corp.'s investment in Scott				<u>\$1,852,500</u>

Accounting Practice

1M89

Answer 5 (cont.)

c.

Poe Corp. SCHEDULE OF INVESTMENT INCOME For the Year Ended December 31, 1988

Dividends:

Axe Corp. — preferred (1,000 shares × \$2.40 per share)	\$ 2,400	
Purl, Inc. — common (3,500 shares × \$1.00 per share)	<u>3,500</u>	
Total dividend revenue		\$ 5,900

Gains on marketable equity securities:

Unrealized gain on current marketable equity securities	7,000	[1]	
Realized gain/(loss) on sale of securities:			
Purl, Inc. — common (\$13 - \$10 = \$3 × 2,500 shares)	\$ 7,500		
Day Co. — common (\$55,000/2,000 shares × 110%), or cost per share of \$25 - \$21 selling price per share = \$4 loss per share × 500 shares sold	<u>(2,000)</u>		
Net realized gain on sale of securities		<u>5,500</u>	
Net gains on current marketable equity securities			12,500

Equity in income of Scott Corp.:

Poe's 30% interest in Scott's net income of \$1,200,000	360,000	
Amortization of excess of cost over underlying equity	<u>(7,500)</u>	[2]
Equity in income of Scott Corp.		<u>352,500</u>
		<u>\$370,900</u>

Explanation of Amounts:

- [1] The valuation allowance of \$7,000 at December 31, 1987 for current marketable equity securities should be eliminated by a debit to valuation allowance — current, and a credit to unrealized gain on current marketable equity securities. The \$7,000 unrealized gain should be included in Poe's income statement for the year ended December 31, 1988.
- [2] Poe's acquisition price for its 30% interest \$1,700,000
Poe's interest in the underlying equity 1,400,000
Excess of cost over underlying equity \$ 300,000
Amortization based on 40 years \$ 7,500

Unofficial Answers

1N86

Answer 4 (10 points)

a.

1.

Lee, Inc.
**SCHEDULE OF LONG-TERM INVESTMENT
PORTFOLIO IN MARKETABLE EQUITY SECURITIES
CARRIED AT LOWER OF COST OR MARKET
December 31, 1985**

	<u>Date</u>	<u>Ewing</u>	<u>Fox</u>	<u>Total</u>
<u>At Cost</u>				
	<u>Date</u>			
12/31/84	\$125,000	\$160,000	\$700,000	\$985,000
7/1/85			(700,000)	(700,000)
8/5/85		(16,000) [1]		(16,000)
12/31/85	<u>\$125,000</u>	<u>\$144,000</u>	<u>\$ —</u>	<u>269,000</u>
<u>At Market</u>				
	<u>12/31/85</u>			
Shares	5,500 [2]	10,000		
Price per share	× \$23	× \$14		
	<u>\$126,500</u>	<u>\$140,000</u>		<u>266,500</u>
Valuation allowance to reduce long-term investments in marketable equity securities to market value				<u>\$ 2,500</u>

2.

Lee, Inc.
**SCHEDULE OF LONG-TERM INVESTMENT
MARKETABLE EQUITY SECURITIES
CARRIED AT EQUITY
December 31, 1985**

Investment in Fox Corp., at Equity

	<u>Underlying equity</u>	<u>Excess of cost</u>	<u>Total at equity</u>	
10% interest, 1/2/84	\$ 580,000	\$120,000	\$ 700,000	[3]
Equity in earnings, 1984	35,000		35,000	[4]
Amortization of excess cost		(3,000)	(3,000)	[5]
Balance, 12/31/84	615,000	117,000	732,000	
Period 1/1/85 to 6/30/85				
Equity in earnings	20,000		20,000	[4]
Amortization of excess cost		(1,500)	(1,500)	[5]
Balance, 6/30/85	635,000	115,500	750,500	
20% interest, 7/1/85	1,270,000	250,000	1,520,000	
Period 7/1/85 to 12/31/85				
Equity in earnings	111,000		111,000	[4]
Amortization of excess cost		(4,625)	(4,625)	[5]
Dividend, 10/1/85	(97,500)		(97,500)	[6]
Balance, 12/31/85	<u>\$1,918,500</u>	<u>\$360,875</u>	<u>\$2,279,375</u>	

1N86

Answer 4 (cont.)

b.

Lee, Inc.
SCHEDULE OF INVESTMENT INCOME
For the Year Ended December 31, 1985

Dividends		
Dale Corp., common stock	\$ 4,125	[7]
Realized gain on sale of securities		
Ewing Corp., stock rights	\$ 2,800	[8]
Equity in earnings of Fox Corp.		
Lee's 10% interest in earnings for period January 1 to June 30, 1985	\$ 20,000	[4]
Lee's 30% interest in earnings for period July 1 to December 31, 1985	111,000	[4]
Amortization of excess of cost over underlying equity	(6,125)	[5]
Equity in earnings of Fox Corp.	<u>\$124,875</u>	

Explanations of Amounts:

[1] Ewing common — Allocation of cost to stock and stock rights		
Market prices at 8/5/85, date rights issued:		
Shares — \$13.50 per share × 10,000 shares	\$135,000	(90%)
Rights — \$ 1.50 per right × 10,000 rights	15,000	(10%)
	<u>\$150,000</u>	(100%)
Cost allocated to shares (90% × \$160,000)	\$144,000	
Cost allocated to rights (10% × \$160,000)	16,000	
Total Cost	<u>\$160,000</u>	
[2] Dale common shares		
Balance, 12/31/84	5,000	
10% stock dividend, 5/1/85	500	
Total, 12/31/85	<u>5,500</u>	
[3] 10% Interest, 1/2/84		
Underlying equity (10% × \$5,800,000)	\$580,000	
Excess of cost	120,000	
Total paid for 10% interest	<u>\$700,000</u>	
[4] Equity in earnings of Fox		
Year ended 12/31/84		
(10% interest × \$350,000)	<u>\$ 35,000</u>	
Period 1/1/85 to 6/30/85		
(10% interest × \$200,000)	<u>\$ 20,000</u>	
Period 7/1/85 to 12/31/85		
(30% interest × \$370,000)	<u>\$111,000</u>	

Unofficial Answers

[5] Amortization of excess cost	
Year ended 12/31/84 ($\$120,000 \div 40$)	<u>\$3,000</u>
Period 1/1/85 to 6/30/85 ($\$3,000 \times \frac{1}{2}$)	<u>\$1,500</u>
Period 7/1/85 to 12/31/85	
10% interest	\$1,500
20% interest ($\$250,000 \div 40 \times \frac{1}{2}$)	<u>3,125</u>
	<u>\$4,625</u>
Total for year ended 12/31/85	<u>\$6,125</u>
[6] Dividends received from Fox	
10/1/85 (75,000 shares \times \$1.30)	<u>\$97,500</u>
[7] Dividend on Dale Corp. stock	
Shares owned	5,500 [2]
\times \$0.75 per share 11/1/85	<u>\times \$0.75</u>
Dividend received	<u>\$ 4,125</u>
[8] Realized gain on sale of Ewing Corp. stock rights	
Sales proceeds, 12/16/85	\$18,800
Cost allocated to rights	<u>16,000 [1]</u>
Realized gain	<u>\$ 2,800</u>

B. Receivables and Accruals

1M88

Answer 5 (10 points)

a.

Rowe Corp.
SCHEDULE OF CHANGES IN NOTE
FROM SALE OF PATENT
1987

Face amount, 5/1/87 (due 5/1/90)	\$500,000
Deduct imputed interest	
$[\$500,000 - (\$500,000 \times 0.675)]$	<u>162,500</u>
Balance, 5/1/87	337,500
Add interest earned to 12/31/87	
$(\$337,500 \times 14\% \times \frac{8}{12})$	<u>31,500</u>
Balance, 12/31/87, noncurrent	<u>\$369,000</u>

Rowe Corp.
SCHEDULE OF CHANGES IN INSTALLMENT
CONTRACT RECEIVABLE
1987

Balance, 12/31/86	\$720,000
Deduct payment, 3/31/87	<u>180,000</u>
Balance, 3/31/87 and 12/31/87	540,000
Deduct installment due 3/31/88	<u>180,000</u>
Balance, 12/31/87, noncurrent	<u>\$360,000</u>

Accounting Practice

1M88

Answer 5 (cont.)

Rowe Corp.
**SCHEDULE OF CHANGES IN INVESTMENT
IN BLACK CORP., AT EQUITY**
1987

	<u>Underlying equity</u>		<u>Goodwill</u>	<u>Total at equity</u>
25% interest, 7/1/87	\$1,600,000	[1]	\$280,000	\$1,880,000
Period 7/1/87 to 12/31/87				
Equity in earnings	176,000	[2]		176,000
Dividend, 11/30/87	(150,000)	[3]		(150,000)
Amortization of goodwill			(3,500)	(3,500)
Balance, 12/31/87	<u>\$1,626,000</u>		<u>\$276,500</u>	<u>\$1,902,500</u>

Rowe Corp.
SCHEDULE OF CHANGES IN PATENT
1987

Cost, net of accumulated amortization, 12/31/86	\$ 245,000
Deduct amortization, 1/1/87 to 5/1/87 ($\$315,000 \div 15 \times \frac{4}{12}$)	<u>(7,000)</u>
	238,000
Cost of patent sold, 5/1/87	<u>(238,000)</u>
Balance, 12/31/87	<u>\$ 0</u>

Rowe Corp.
SCHEDULE OF CHANGES IN TRADEMARK
1987

Cost, 1/2/87	\$250,000
Deduct amortization for 1987 ($\$250,000 \div 40$)	<u>6,250</u>
Balance, net of accumulated amortization, 12/31/87	<u>\$243,750</u>

Explanations of Amounts

Underlying equity ($25\% \times \$6,400,000$)	<u>\$1,600,000</u>	[1]
Equity in earnings ($25\% \times \$704,000$)	<u>\$ 176,000</u>	[2]
Dividend, 11/30/87 ($\$2 \times 75,000$ shares)	<u>\$ 150,000</u>	[3]
Amortization of goodwill ($\$280,000 \div 40 \times \frac{1}{2}$)	<u>\$ 3,500</u>	[4]

Unofficial Answers

b.

Rowe Corp.

**SCHEDULE OF REVENUES, GAINS, AND EXPENSES
RELATING TO OTHER NONCURRENT ASSETS
For the Year Ended December 31, 1987**

Gain recognized on sale of patent	<u>\$ 99,500</u>	[5]
Interest revenue		
Noninterest bearing note	\$ 31,500	[Part a]
Installment contract	<u>76,050</u>	[6]
Total	<u>\$107,550</u>	
Equity in earnings of Black Corp.	<u>\$172,500</u>	[7]
Amortization expense — intangibles		
Patent	\$ 7,000	[Part a]
Trademark	<u>6,250</u>	[Part a]
Total	<u>\$ 13,250</u>	

Explanations of Amounts

[5] Gain recognized on sale of patent			
Selling price (net of imputed interest)		\$337,500	[Part a]
Carrying amount of patent at date of sale		<u>238,000</u>	[Part a]
Gain recognized		<u>\$ 99,500</u>	
[6] Interest revenue — installment contract			
Interest received 3/31/87 ($\$720,000 \times 13\%$)	\$93,600		
Interest 1/1/87 to 3/31/87	<u>$\times \frac{1}{4}$</u>	\$ 23,400	
Interest accrued 4/1/87 to 12/31/87			
($\$540,000 \times 13\% \times 9/12$)		<u>52,650</u>	
Interest, year ended 12/31/87		<u>\$ 76,050</u>	
[7] Equity in earnings of Black Corp.			
Equity in Black's net income for 1987		\$176,000	[2]
Deduct amortization of goodwill		<u>3,500</u>	[4]
Equity in earnings of Black Corp.		<u>\$172,500</u>	

Accounting Practice

D. Property, Plant, and Equipment Owned or Leased

1N88

Answer 4 (10 points)

a.

Cord Company
ANALYSIS OF CHANGES IN PLANT ASSETS
For the Year Ended December 31, 1987

	<i>Balance</i> <u>12/31/86</u>	<i>Increase</i>		<i>Decrease</i>	<i>Balance</i> <u>12/31/87</u>
Land	\$ 175,000	\$ 312,500	[1]	\$ —	\$ 487,500
Land improvements	—	192,000		—	192,000
Buildings	1,500,000	937,500	[1]	—	2,437,500
Machinery and equipment	1,125,000	385,000	[2]	17,000	1,493,000
Automobiles and trucks	172,000	12,500		24,000	160,500
Leasehold improvements	216,000	—		—	216,000
	<u>\$3,188,000</u>	<u>\$1,839,500</u>		<u>\$41,000</u>	<u>\$4,986,500</u>

Explanations of Amounts:

- [1] Plant facility acquired from King 1/6/87 —
 allocation to Land and Building
 Fair value — 25,000 shares of Cord
 common stock at \$50 market price

\$1,250,000

Allocation in proportion to appraised
 values at the exchange date

	<i>Amount</i>	<i>% to</i> <i>Total</i>
Land	\$187,500	25
Building	562,500	75
	<u>\$750,000</u>	<u>100</u>

Land	(\$1,250,000 × 25%)	\$ 312,500
Building	(\$1,250,000 × 75%)	<u>937,500</u>

\$1,250,000

- [2] Machinery and equipment purchased 7/1/87
 Invoice cost
 Delivery cost
 Installation cost
 Total acquisition cost

\$ 325,000
 10,000
 50,000
\$ 385,000

Unofficial Answers

b.

Cord Company
DEPRECIATION AND AMORTIZATION EXPENSE
For the Year Ended December 31, 1987

Land improvements

Cost	\$ 192,000	
Straight-line rate (100% ÷ 12)	<u>× 8⅓%</u>	
Annual depreciation	16,000	
Depreciation on land improvements for 1987 (3/25 to 12/31/87)	<u>× ¾</u>	<u>\$ 12,000</u>

Buildings

Carrying amount, 1/1/87 (\$1,500,000 – \$328,900)	\$1,171,100	
Building acquired 1/6/87	<u>937,500</u>	
Total amount subject to depreciation	2,108,600	
150% declining balance rate [(100% ÷ 25) × 1.5]	<u>× 6%</u>	
Depreciation on buildings for 1987		<u>126,516</u>

Machinery and equipment

Balance, 1/1/87	\$1,125,000	
Straight-line rate (100% ÷ 10)	<u>× 10%</u>	112,500
Purchased 7/1/87	385,000	
Depreciation for 1987 (10% × 6/12)	<u>× 5%</u>	19,250
Depreciation on machinery and equipment for 1987		<u>131,750</u>

Automobiles and trucks

Carrying amount, 1/1/87 (\$172,000 – \$100,325)	\$ 71,675	
Deduct carrying amount, 1/1/87 on truck sold 9/30/87 (\$9,100 + \$2,650)	<u>11,750</u>	
Amount subject to depreciation	59,925	
150% declining balance rate [(100% ÷ 5) × 1.5]	<u>× 30%</u>	17,978
Automobile purchased 8/30/87	12,500	
Depreciation for 1987 (30% × 4/12)	<u>× 10%</u>	1,250
Truck sold 9/30/87 – depreciation for 1987 (1/1 to 9/30/87)		<u>2,650</u>
Depreciation on automobiles and trucks for 1987		<u>21,878</u>

Leasehold improvements

Carrying amount, 1/1/87 (\$216,000 – \$108,000)	\$108,000	
Amortization period (1/1/87 to 12/31/91)	<u>÷ 5 years</u>	
Amortization in leasehold improvements for 1987		<u>21,600</u>

Total depreciation and amortization expense for 1987		<u><u>\$313,744</u></u>
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Accounting Practice

1N87

Answer 4 (10 points)

a.

Pell Corporation
ANALYSIS OF CHANGES IN PLANT ASSETS
For the Year Ended December 31, 1986

	<i>Balance 12/31/85</i>	<i>Increase</i>	<i>Decrease</i>	<i>Balance 12/31/86</i>
Land	\$ 350,000	\$438,000 [1]	\$ —	\$ 788,000
Land improvements	180,000	—	—	180,000
Building	1,500,000	—	—	1,500,000
Machinery and equipment	1,158,000	287,000 [2]	58,000	1,387,000
Automobiles	150,000	19,000 [3]	18,000	151,000
Total	<u>\$3,338,000</u>	<u>\$744,000</u>	<u>\$76,000</u>	<u>\$4,006,000</u>

Explanations of Amounts:

[1] Cost of land acquired 11/1/86	
Pell stock exchanged (10,000 × \$38)	\$380,000
Legal fees and title insurance	23,000
Razing existing building	35,000
	<u>\$438,000</u>
[2] Cost of machinery and equipment purchased 1/2/86	
Invoice cost	\$260,000
Installation cost	27,000
	<u>\$287,000</u>
[3] Cost recorded for new automobile 12/31/86	
Carrying amount of trade-in	
[\$18,000 – \$13,500 (depreciation 150% declining	
balance at rate of 50% for 2 years)]	\$ 4,500
Cash paid	15,250
Subtotal	\$19,750
Loss on trade-in	750
Cost recorded for new automobile	<u>\$19,000</u>

Unofficial Answers

b.

Pell Corporation
DEPRECIATION EXPENSE
For the Year Ended December 31, 1986

Land improvements			
Cost		\$ 180,000	
Straight-line rate $[100\% \div 15]$		<u>$\times 6\frac{2}{3}\%$</u>	
Total depreciation on land improvements			<u>\$ 12,000</u>
Building			
Carrying amount 12/31/85 (\$1,500,000 - \$350,000)		\$1,150,000	
150% declining balance rate $[(100\% \div 20) \times 1\frac{1}{2}]$		<u>$\times 7\frac{1}{2}\%$</u>	
Total depreciation on building			<u>86,250</u>
Machinery and equipment			
Balance, 12/31/85	\$1,158,000		
Deduct machine sold 3/31/86	<u>58,000</u>	\$1,100,000	
Depreciation straight-line rate		<u>$\times 10\%$</u>	110,000
Purchased 1/2/86		287,000	
Depreciation		<u>$\times 10\%$</u>	28,700
Machine sold 3/31/86		58,000	
Depreciation from 1/1 to 3/31/86 $(10\% \times \frac{1}{4})$		<u>$\times 2.5\%$</u>	1,450
Total depreciation on machinery and equipment			<u>140,150</u>
Automobiles			
Carrying amount 12/31/85 (\$150,000 - \$112,000)		\$ 38,000	
150% declining balance rate $[100\% \div 3 \times 1\frac{1}{2}]$		<u>$\times 50\%$</u>	
Total depreciation on automobiles			<u>19,000</u>
Total depreciation expense for 1986			<u><u>\$257,400</u></u>

c.

Pell Corporation
GAIN OR LOSS FROM PLANT ASSET DISPOSALS
THAT WOULD BE RECOGNIZED IN INCOME STATEMENT
For the Year Ended December 31, 1986

	<i>Gain or (loss)</i>	
Sale of machine 3/31/86		
Selling price	\$36,500	
Carrying amount of machine sold [\$58,000 - \$24,650 (Depreciation $4\frac{1}{4}$ years $\times 10\%$)]	<u>33,350</u>	
Gain on sale	<u>3,150</u>	
Trade-in of automobile 12/31/86		
Carrying amount of trade-in	\$ 4,500	[3]
Trade-in allowed (\$19,000 - \$15,250)	<u>3,750</u>	
Loss on trade-in	<u>\$ (750)</u>	
Gain from asset disposals	<u><u>\$ 2,400</u></u>	

Accounting Practice

1M85

Answer 4 (10 points)

a.

Blake Corporation
DEPRECIATION AND AMORTIZATION EXPENSE
For the Year Ended December 31, 1984

Building

Book value 1/1/84 (\$1,200,000 - \$263,100)	\$936,900	
150% declining balance rate $[(100\% \div 25) \times 1.5]$	<u>$\times 6\%$</u>	
Total depreciation on building		<u>\$ 56,214</u>

Machinery and equipment

Balance, 1/1/84	\$900,000	
Deduct machine destroyed by fire	<u>23,000</u>	
Depreciation	<u>\$877,000</u>	
	$\times 10\%$	87,700
Machine destroyed by fire, 4/1/84	\$ 23,000	
Depreciation from 1/1 to 4/1/84 $(10\% \times \frac{3}{12})$	<u>$\times 2.5\%$</u>	575
Purchased 7/1/84	\$310,000	
Depreciation from 7/1 to 12/31/84 $(10\% \times \frac{6}{12})$	<u>$\times 5\%$</u>	15,500
Total depreciation on machinery and equipment		<u>103,775</u>

Automotive equipment

Depreciation on \$115,000 balance, 1/1/84	\$ 18,000	
Deduct depreciation on car traded in 1/2/84 (SYD 3d year $\frac{2}{10} \times \$9,000$)	<u>1,800</u>	16,200
Car purchased, 1/2/84	12,000	
Depreciation SYD 1st year	<u>$\times \frac{4}{10}$</u>	4,800
Total depreciation on automotive equipment		<u>21,000</u>

Leasehold improvements

Cost, 5/1/84	\$168,000	
Amortization period (5/1/84 to 12/31/90)	<u>$\div 80 \text{ mos.}$</u>	
Amortization per month	\$ 2,100	
Amortization for 1984 (5/1 to 12/31/84)	<u>$\times 8 \text{ mos.}$</u>	
Total amortization on leasehold improvements		16,800
Total depreciation and amortization expense for 1984		<u><u>\$197,789</u></u>

Unofficial Answers

Blake Corporation
ACCUMULATED DEPRECIATION AND AMORTIZATION
December 31, 1984

Accumulated depreciation — building at 12/31/84	
Balance, 1/1/84	\$263,100
Depreciation for 1984	<u>56,214</u>
Balance, 12/31/84	<u>\$319,314</u>
Accumulated depreciation — machinery and equipment at 12/31/84	
Balance, 1/1/84	\$250,000
Depreciation for 1984	<u>103,775</u>
	353,775
Deduct machine destroyed by fire ($5 \times 10\% \times \$23,000$)	<u>11,500</u>
Balance, 12/31/84	<u>\$342,275</u>
Accumulated depreciation — automotive equipment at 12/31/84	
Balance, 1/1/84	\$ 84,600
Depreciation for 1984	<u>21,000</u>
	105,600
Deduct car traded in ($\$9,000 - \$2,700$)	<u>6,300</u>
Balance, 12/31/84	<u>\$ 99,300</u>
Accumulated amortization — leasehold improvements at 12/31/84	
Amortization for 1984	<u>\$ 16,800</u>
Balance, 12/31/84	<u>\$ 16,800</u>
Total accumulated depreciation and amortization at 12/31/84	<u><u>\$777,689</u></u>

b.

Blake Corporation
GAIN OR LOSS FROM DISPOSAL OF ASSETS
For the Year Ended December 31, 1984

Gain on machine destroyed by fire	
Insurance recovery	\$ 15,500
Book value of machine destroyed	
[$\$23,000 - (5 \times 10\% \times \$23,000)$]	<u>11,500</u>
	\$ 4,000
Loss on car traded in on new car purchase	
Book value of car traded in	\$ 2,700
Trade-in allowed ($\$12,000 - \$10,000$)	<u>2,000</u>
	700
Net gain on asset disposals for 1984	<u><u>\$ 3,300</u></u>

Accounting Practice

1M85

Answer 4 (cont.)

c.

Blake Corporation
PROPERTY, PLANT, AND EQUIPMENT SECTION
OF BALANCE SHEET
December 31, 1984

	<u>Cost</u>		<u>Accumulated depreciation and amortization</u>		<u>Book value</u>
Land	\$ 150,000		\$ —		\$ 150,000
Building	1,200,000		319,314		880,686
Machinery and equipment	1,187,000	[1]	342,275		844,725
Automotive equipment	118,000	[2]	99,300		18,700
Leasehold improvements	168,000		16,800		151,200
Totals	<u>\$2,823,000</u>		<u>\$777,689</u>		<u>\$2,045,311</u>

Explanations of Amounts

[1] Machinery and equipment at 12/31/84	
Balance, 1/1/84	\$ 900,000
Purchased, 7/1/84 (\$280,000 + \$5,000 + \$25,000)	310,000
	<u>1,210,000</u>
Deduct machine destroyed by fire 4/1/84	23,000
Balance, 12/31/84	<u>\$1,187,000</u>
[2] Automotive equipment at 12/31/84	
Balance, 1/1/84	\$ 115,000
Car purchased, 1/2/84	12,000
	<u>127,000</u>
Deduct car traded in	9,000
Balance, 12/31/84	<u>\$ 118,000</u>

E. Intangibles and Other Assets

1N85

Answer 4 (10 points)

a.

Munn, Inc.
SCHEDULE OF EXPENSES RELATING TO OTHER NONCURRENT ASSETS
For the Year Ended December 31, 1984

Amortization of intangibles		
Patent	\$ 28,000	[1]
Trademark	15,000	[2]
Non-competition agreement	40,000	[3]
Total	<u>\$ 83,000</u>	
Consulting fee to Cody Corporation	<u>\$ 50,000</u>	
Deferred income tax expense	<u>\$ 2,000</u>	[4]

Unofficial Answers

b.

Munn, Inc.

**OTHER NONCURRENT ASSETS SECTION
OF BALANCE SHEET**

December 31, 1984

Investment in bonds	\$ 929,150	[5]
Patent, net of accumulated amortization of \$52,000	140,000	[6]
Trademark, net of accumulated amortization of \$15,000	585,000	[7]
Non-competition agreement, net of accumulated amortization of \$40,000	160,000	[8]
Deferred income tax charges	<u>34,000</u>	[9]
Total other noncurrent assets	<u><u>\$1,848,150</u></u>	

Explanations of Amounts

[1] Amortization of patent	
Patent balance, 12/31/83 (\$192,000 – \$24,000)	\$ 168,000
Life of patent (6 years from 12/31/83)	÷ 6
Amortization for 1984	<u>\$ 28,000</u>
[2] Amortization of trademark	
Cost of trademark, 1/3/84 ($\$800,000 \times \frac{3}{4}$)	\$ 600,000
Life of trademark (maximum 40 years)	÷ 40
Amortization for 1984	<u>\$ 15,000</u>
[3] Amortization of non-competition agreement	
Cost of non-competition agreement, 1/3/84 ($\$800,000 \times \frac{1}{4}$)	\$ 200,000
Life of agreement (5 years)	÷ 5
Amortization for 1984	<u>\$ 40,000</u>
[4] Deferred income tax expense	
Timing differences for 1984	
Excess of book rent income over tax rent income of \$20,000 × 40%	\$ 8,000
Deduct excess of book warranty expense over tax warranty deduction of \$15,000 × 40%	<u>6,000</u>
Net expense for 1984	<u><u>\$ 2,000</u></u>
[5] Investment in bonds	
Cost of bonds, 7/1/84	\$ 923,000
Add amortization of discount from 7/1 to 12/31/84 (\$46,150 – \$40,000)	\$ 6,150
Balance, 12/31/84	<u><u>\$ 929,150</u></u>

Accounting Practice

1N85

Answer 4 (cont.)

[6] Patent, net of accumulated amortization			
Cost of patent, 1/1/82	\$ 192,000		
Deduct accumulated amortization, 12/31/83	24,000		
Patent balance, 12/31/83	\$ 168,000		
Deduct amortization for 1984	28,000		[1]
Balance, 12/31/84	<u>\$ 140,000</u>		
[7] Trademark, net of accumulated amortization			
Cost of trademark, 1/3/84	\$ 600,000		[2]
Deduct amortization for 1984	\$ 15,000		[2]
Balance, 12/31/84	<u>\$ 585,000</u>		
[8] Non-competition agreement, net of accumulated amortization			
Cost of non-competition agreement, 1/3/84	\$ 200,000		[3]
Deduct amortization for 1984	40,000		[3]
Balance, 12/31/84	<u>\$ 160,000</u>		
[9] Deferred income tax charges			
Balance, 12/31/83	\$ 36,000		
Deduct charge to expense for 1984	\$ 2,000		[4]
Balance, 12/31/84	<u>\$ 34,000</u>		

**III. Valuation, Recognition, and Presentation of Liabilities in Conformity With
Generally Accepted Accounting Principles**

2N88

Answer 4 (10 points)

a.

Lino Corporation
**LONG-TERM LIABILITIES SECTION
OF BALANCE SHEET**
December 31, 1987

10% note payable to bank, due in annual installments of \$200,000, less current installment	\$ 400,000	[1]
Liability under capital lease, net present value of lease payments, less current installment	160,768	[2]
10% bonds payable due July 1, 1997, less unamortized discount of \$243,750	756,250	[3]
Deferred income taxes	<u>115,000</u>	[4]
Total long-term liabilities	<u>\$1,432,018</u>	

Unofficial Answers

b.

Lino Corporation
INTEREST EXPENSE
For the Year Ended December 31, 1987

Note payable to bank	\$ 75,000	[5]
Liability under capital lease	44,800	[2]
Bonds payable	56,250	[3]
Total	<u>\$ 176,050</u>	

Explanations of Amounts

[1]	10% Note payable to bank		
	Note payable, 12/31/86		\$800,000
	Less installment paid 10/1/87		<u>200,000</u>
	Balance, 12/31/87		600,000
	Less current installment due 10/1/88		<u>200,000</u>
	Long-term portion, 12/31/87		<u>\$400,000</u>
[2]	Liability under capital lease		
	Liability under capital lease, 12/31/86		\$280,000
	Less principal portion of 12/31/87 payment		
	Lease payment	\$100,000	
	Less imputed interest ($\$280,000 \times 16\%$)	<u>44,800</u>	55,200
	Balance, 12/31/87		224,800
	Less current principal payment due 12/31/88		
	Lease payment	100,000	
	Less imputed interest ($\$224,800 \times 16\%$)	<u>35,968</u>	64,032
	Long-term portion, 12/31/87		<u>\$160,768</u>
[3]	Bonds payable		
	Bonds payable issued 7/1/87		\$750,000
	Add amortization of bond discount		
	Effective interest ($\$750,000 \times 15\% \times \frac{6}{12}$)	56,250	
	Less accrued interest payable 12/31/87		
	($\$1,000,000 \times 10\% \times \frac{6}{12}$)	<u>50,000</u>	6,250
	Balance, 12/31/87		<u>\$756,250</u>
[4]	Deferred income taxes		
	Deferred income taxes, 12/31/86		\$100,000
	Add timing difference — excess of tax depreciation		
	over book depreciation of $\$50,000 \times 30\%$		<u>15,000</u>
	Balance, 12/31/87		<u>\$115,000</u>
[5]	Interest expense on note payable to bank		
	1/1/87 to 9/30/87 ($\$800,000 \times 10\% \times \frac{9}{12}$)		\$ 60,000
	10/1/87 to 12/31/87 ($\$600,000 \times 10\% \times \frac{3}{12}$)		<u>15,000</u>
	Interest, year ended 12/31/87		<u>\$ 75,000</u>

Accounting Practice

1M88

Answer 4 (10 points)

a.

Fay, Inc.
**LONG-TERM LIABILITIES SECTION
OF BALANCE SHEET**
December 31, 1987

9% unsecured note payable to bank, due in annual principal installments of \$800,000, less current portion	\$ 3,200,000	[1]
11% debenture bonds payable due December 31, 1999, plus unamortized premium of \$337,640	<u>5,337,640</u>	[2]
Total long-term liabilities	<u><u>\$ 8,537,640</u></u>	

b.

Fay, Inc.
**STOCKHOLDERS' EQUITY SECTION
OF BALANCE SHEET**
December 31, 1987

Common stock, \$10 par; 2,000,000 shares authorized; 840,000 shares issued; 829,500 shares outstanding	\$ 8,400,000	[3]
Additional paid-in capital	2,485,000	[4]
Retained earnings	<u>4,765,000</u>	[5]
	15,650,000	
Less: net unrealized loss on noncurrent marketable equity securities	\$ 20,000	[6]
Treasury stock, at cost, 10,500 shares	<u>130,000</u>	[7]
	<u>(150,000)</u>	
Total stockholders' equity	<u><u>\$15,500,000</u></u>	

c.

Fay, Inc.
INTEREST EXPENSE
For the Year Ended December 31, 1987

Note payable to bank	\$ 60,000	[8]
Debenture bonds payable	<u>535,240</u>	[9]
Total interest expense	<u><u>\$ 595,240</u></u>	

Explanations of Amounts

[1] 9% note payable to bank	
Note payable, 11/1/87	\$4,000,000
Deduct installment due 11/1/88	<u>800,000</u>
Long-term portion, 12/31/87	<u><u>\$3,200,000</u></u>

Unofficial Answers

[2] Debenture bonds payable			
Carrying amount, 12/31/86			\$5,352,400
Deduct amortization of bond premium			
Interest paid 12/31/87 ($\$5,000,000 \times 11\%$)	\$550,000		
Less effective interest			
($\$5,352,400 \times 10\%$)	<u>535,240</u>		<u>14,760</u>
Carrying amount, 12/31/87			<u><u>\$5,337,640</u></u>
[3] Common stock issued			
	<u>Date</u>	<u>Shares</u>	<u>Amount</u>
Balance	12/31/86	800,000	\$8,000,000
5% stock dividend issued	3/2/87	40,000	400,000
Balance	12/31/87	<u>840,000</u>	<u>\$8,400,000</u>
[4] Additional paid-in capital			
Balance, 12/31/86			\$2,295,000
Treasury stock reissued, 1/15/87			
[$\$225,000 - \$195,000 (\$325,000 \times 60\%)$]			30,000
Stock dividend issued, 3/2/87			
[$(\$14 - \$10) \times 40,000 \text{ shares}$]			<u>160,000</u>
Balance, 12/31/87			<u><u>\$2,485,000</u></u>
[5] Retained earnings			
Balance, 12/31/86			\$2,465,000
Stock dividend issued, 3/2/87			
($\$14 \times 40,000 \text{ shares}$)			(560,000)
Net income for 1987			<u>2,860,000</u>
Balance, 12/31/87			<u><u>\$4,765,000</u></u>
[6] Net unrealized loss on noncurrent marketable equity securities			
Balance, 12/31/87			
[$(\$20 - \$18) \times 10,000 \text{ shares}$]			<u>\$ 20,000</u>
[7] Treasury stock at cost			
($10,000 \div 25,000 \times \$325,000$)			<u><u>\$130,000</u></u>
[8] Interest expense on note payable to bank			
[11/1/87 to 12/31/87 ($\$4,000,000 \times 9\% \times \frac{2}{12}$)]			<u><u>\$ 60,000</u></u>
[9] Interest expense on debenture bonds payable			
Interest paid 12/31/87 for year ended 12/31/87			\$550,000 [2]
Deduct amortization of bond premium for year			<u>14,760 [2]</u>
Interest expense year ended 12/31/87			<u><u>\$535,240</u></u>

Accounting Practice

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

A. Preferred and Common Stock

1M86

Answer 4 (10 points)

a.

Carr Corporation
STATEMENT OF RETAINED EARNINGS
For the Year Ended December 31, 1985

Balance, December 31, 1984		
As originally reported		\$4,000,000
Deduct prior period adjustment from error overstating rent income for year ended December 31, 1984	\$500,000	
Less income tax effect	<u>225,000</u>	<u>275,000</u>
As restated		3,725,000
Net income		<u>2,600,000</u>
		6,325,000
Deduct dividends		
Cash dividend on preferred stock	180,000 [1]	
Dividend in kind on common stock	<u>630,000 [2]</u>	<u>810,000</u>
Balance, December 31, 1985		<u><u>\$5,515,000</u></u>

b.

Carr Corporation
STOCKHOLDERS' EQUITY SECTION OF BALANCE SHEET
December 31, 1985

Preferred stock, \$100 par, 10% cumulative; 100,000 shares authorized; 18,000 shares issued and outstanding		\$ 1,800,000
Common stock, \$5 stated value; 3,000,000 shares authorized, 1,290,000 shares issued and outstanding		6,450,000 [3]
Additional paid-in capital		
From preferred stock	\$ 90,000	
From common stock	<u>4,880,000 [4]</u>	
Total additional paid-in capital		4,970,000
Retained earnings		<u>5,515,000</u>
		18,735,000
Less net unrealized loss on noncurrent marketable equity securities		<u>135,000</u>
Total stockholders' equity		<u><u>\$18,600,000</u></u>

Explanations of Amounts

[1] Cash dividend on preferred stock for 1985	
Shares outstanding	18,000
Dividend per share (\$100 par × 10%)	× \$10
Total dividend	<u><u>\$180,000</u></u>

Unofficial Answers

[2] Dividend in kind on common stock for 1985			
Bush, Inc., common stock shares			10,000
Market price on 2/15/85 declaration date			× \$63
Total dividend			<u>\$630,000</u>
[3] Common stock			
	<u>Date</u>	<u>Shares</u>	<u>Amount</u>
Balance	12/31/84	1,030,000	\$5,150,000
Deduct treasury stock retired	1/10/85	30,000	150,000
		<u>1,000,000</u>	<u>5,000,000</u>
Stock rights exercised	4/25/85	210,000	1,050,000
Employee stock options exercised	7/1/85	80,000	400,000
Balance	12/31/85	<u>1,290,000</u>	<u>\$6,450,000</u>
[4] Additional paid-in capital from common stock			
12/31/84, balance			\$3,500,000
1/10/85, deduct treasury stock retired (\$270,000 – \$150,000)			120,000
			<u>3,380,000</u>
4/25/85, stock rights exercised [(\$11 – \$5) × 210,000 shares]			1,260,000
7/1/85, employee stock options exercised [(\$8 – \$5) × 80,000 shares]			240,000
12/31/85, balance			<u>\$4,880,000</u>

VII. Cost Accumulation, Planning, and Control

2M89

Answer 5 (10 points)

a. *Tapa Wholesale Company*
PRICING FUNCTION BUDGET
For the Year Ending December 31, 1989

Variable costs:	
Wages	\$66,000
Payroll taxes	6,600
Workers' compensation insurance	3,300
Supplies	1,500
Total variable costs	<u>77,400</u>
Fixed costs	<u>3,400</u>
Total costs	<u>\$80,800</u>

COMPUTATIONS

<u>Wages</u>		<u>Payroll taxes</u>	
Number of items priced in 1988		\$66,000 × 10%	<u>\$ 6,600</u>
(20,000 × 4)	80,000		
Projected number of items priced		<u>Workers' compensation insurance</u>	
in 1989 (24,000 × 5)	120,000	\$66,000 × 5%	<u>\$ 3,300</u>
Average wage cost per item in 1988		<u>Supplies</u>	
(\$40,000/80,000)	\$0.50	1989 projected multiple of number of 1988 items	
Projected wage cost in 1989		(120,000/80,000)	1.5 times
(120,000 @ \$0.50 + 10%)	<u>\$66,000</u>	\$1,000 × 1.5	<u>\$ 1,500</u>

2M89

Answer 5 (cont.)

b.

Tapa Wholesale Company
**COMPUTATION OF STANDARD DELIVERY
 COST PER UNIT OF PRODUCT**
For the Year Ending December 31, 1989

<u>Product</u>	<u>Units</u>	<u>Unit capacity per truck</u>	<u>Number of deliveries projected</u>	<u>Variable costs per delivery</u>	<u>Variable costs per unit delivered</u>	<u>Fixed costs</u>	<u>Total</u>
Arcil	60,000	10	6,000	\$12	\$1.20	\$0.25	\$1.45
Balo	40,000	5	8,000	12	2.40	0.25	2.65
Cacha	20,000	4	5,000	12	3.00	0.25	3.25
Totals	<u>120,000</u>		<u>19,000</u>				

Variable cost per delivery:

Total number of deliveries	19,000
Variable costs	\$228,000
Variable costs per delivery	\$12

Fixed costs per unit:

Total number of units	120,000
Fixed costs	\$30,000
Fixed costs per unit	\$0.25

2N88

Answer 5 (10 points)

a.

Amar Supermarkets Corp.
Plan 1
**ALLOCATION OF CORPORATION OVERHEAD
 ON THE BASIS OF SALES**
For the Year Ended December 31, 1987

<u>Store</u>	<u>Allocation</u>	<u>Corporation overhead</u>	<u>Income before corporation overhead</u>	<u>Income after corporation overhead</u>
Birch	$\frac{5}{12} = 42\%$	\$ 42,000	\$ 84,000	\$42,000
Maple	$\frac{4}{12} = 33\%$	33,000	37,000	4,000
Spruce	$\frac{3}{12} = 25\%$	25,000	29,000	4,000
Totals		<u>\$100,000</u>	<u>\$150,000</u>	<u>\$50,000</u>

Unofficial Answers

Plan 2
**ALLOCATION OF CORPORATION OVERHEAD
ON VARIOUS BASES**
For the Year Ended December 31, 1987

	<u>Total</u>	<u>Warehouse operations</u>	<u>Store</u>		
			<u>Birch</u>	<u>Maple</u>	<u>Spruce</u>
Income before corporation overhead	<u>\$150,000</u>		<u>\$84,000</u>	<u>\$37,000</u>	<u>\$29,000</u>
Warehouse operations	<u>15,000</u>	\$15,000			
Central office salaries	<u>30,000</u>	7,500	7,500	7,500	7,500
Other central office overhead	<u>2,000</u>	500	500	500	500
Total warehouse operations	<u>23,000</u>	<u>\$23,000</u>			
Warehouse depreciation	10,000				
Advertising	<u>8,000</u>				
Total — allocated on basis of sales	<u>41,000</u>		17,220	13,530	10,250
Delivery expenses — allocated on basis of miles times deliveries	<u>35,000</u>				
15,000/30,000 = 50%			17,500		
10,000/30,000 = 33%				11,550	
5,000/30,000 = 17%					5,950
Total corporation overhead	<u>100,000</u>		<u>42,720</u>	<u>33,080</u>	<u>24,200</u>
Income after corporation overhead	<u>\$ 50,000</u>		<u>\$41,280</u>	<u>\$ 3,920</u>	<u>\$ 4,800</u>

b.

Amar Supermarkets Corp.
**COMPUTATION OF COST INCREASES
RESULTING FROM PROSPECTIVE INCREASE IN SALES**

	<u>Birch</u>	<u>Maple</u>	<u>Spruce</u>	<u>Total</u>
Sales — 1987	<u>\$500,000</u>	<u>\$400,000</u>	<u>\$300,000</u>	<u>\$1,200,000</u>
Cost of sales — 1987	<u>\$280,000</u>	<u>\$230,000</u>	<u>\$190,000</u>	<u>\$ 700,000</u>
Local variable operating expenses	<u>66,000</u>	<u>73,000</u>	<u>31,000</u>	<u>170,000</u>
Total local variable costs	<u>\$346,000</u>	<u>\$303,000</u>	<u>\$221,000</u>	<u>\$ 870,000</u>
Percent of local variable costs to sales	69%	76%	74%	
Multiplied by prospective increase in sales	<u>\$ 80,000</u>	<u>\$ 80,000</u>	<u>\$ 80,000</u>	
Increase in local variable costs	<u>55,200</u>	<u>60,800</u>	<u>59,200</u>	
*Increase in delivery expenses	<u>1,170</u>	<u>2,340</u>	<u>293</u>	
Increase in relevant expenses (local variable costs and delivery)	<u>\$ 56,370</u>	<u>\$ 63,140</u>	<u>\$ 59,493</u>	

Management should expand the Birch store because costs would increase the least and net income would increase the most. Differential revenues would be the same for all stores, but differential costs would be the least at Birch. Therefore, differential net income would be greatest at Birch.

*COMPUTATION OF INCREASE IN DELIVERY EXPENSES

<u>Store</u>	<u>Miles from warehouse</u>	<u>Additional deliveries</u>	<u>Additional delivery miles</u>	<u>Cost per delivery mile</u>	<u>Total increase</u>
Birch	100	10	1,000	\$1.17	\$1,170
Maple	200	10	2,000	1.17	2,340
Spruce	25	10	250	1.17	293

$$\text{Cost per delivery mile} = \frac{\text{Delivery expenses in 1987}}{\text{Delivery miles in 1987}} = \frac{\$35,000}{30,000} = \underline{\underline{\$1.17}}$$

Accounting Practice

2M88

Answer 5 (10 points)

Seco Corp.
Year Ending December 31, 1989

a. Estimated Breakeven Point Based on Pro Forma Income Statement

Sales		\$10,000,000
Variable costs		
Cost of sales	\$6,000,000	
Commissions	<u>2,000,000</u>	<u>8,000,000</u>
Contribution margin		<u>\$ 2,000,000</u>
Contribution margin ratio ($\$2,000,000 \div \$10,000,000$)		<u>20%</u>
Fixed costs		\$ 100,000
Contribution margin ratio		<u>$\div .20$</u>
Estimated breakeven point		<u><u>\$ 500,000</u></u>

b. Estimated Breakeven Point With Company Employing Its Own Salespersons

Variable cost ratios		
Cost of sales		60%
Commissions		<u>5%</u>
Total		<u>65%</u>
Contribution margin ratio ($100\% - 65\%$)		<u>35%</u>
Fixed costs		
Sales manager		\$ 160,000
3 salespersons @ \$30,000 each		90,000
Administrative		<u>100,000</u>
Total		<u><u>\$ 350,000</u></u>
Fixed costs		\$ 350,000
Contribution margin ratio		<u>$\div .35$</u>
Estimated breakeven point		<u><u>\$ 1,000,000</u></u>

**c. Estimated Sales Volume Yielding Net Income
Projected in Pro Forma Income Statement
With Independent Sales Agents Receiving 25% Commission**

Target income before income tax		\$ 1,900,000
Fixed costs		<u>100,000</u>
Total		<u><u>\$ 2,000,000</u></u>
Variable cost ratios		
Cost of sales		60%
Commissions		<u>25%</u>
Total		<u>85%</u>
Contribution margin ratio ($100\% - 85\%$)		<u>15%</u>

Unofficial Answers

Target income + fixed costs	\$ 2,000,000
Contribution margin ratio	÷ .15
Estimated sales volume	<u>\$13,333,333</u>

d.

**Estimated Sales Volume Yielding An Identical Net Income
Regardless of Whether the Company Employs Its Own Salespersons
or
Continues With Independent Sales Agents and Pays Them 25% Commission**

Total costs with agents receiving 25% commission = Total costs with company's own sales force

X = sales volume

$$\begin{aligned} \frac{\$ 8,500,000}{\$10,000,000} X + \$100,000 &= \frac{\$ 6,500,000}{\$10,000,000} X + \$350,000 \\ .85X + \$100,000 &= .65X + \$350,000 \\ .20X &= \$250,000 \\ X &= \underline{\underline{\$1,250,000}} \end{aligned}$$

2N87

Answer 4 (10 points)

**Webb & Company
March 1987**

a.

(1) Equivalent Units

	<u>Labor</u>	<u>Overhead</u>
Returns completed (200 + 825 - 125)	900	900
Returns in process, 3/31 (125 × 80%)	100	100
Equivalent units	<u>1,000</u>	<u>1,000</u>

(2) Actual Cost Per Equivalent Unit

	<u>Labor</u>	<u>Overhead</u>
Cost of returns in process, 3/1	\$ 6,000	\$ 2,500
Add: March costs	89,000	45,000
Total costs	95,000	47,500
Divided by weighted average equivalent units	÷ 1,000	÷ 1,000
Actual cost per equivalent unit	<u>\$95.00</u>	<u>\$47.50</u>

b. Actual Cost of Returns in Process at 3/31

Labor (125 returns × 80% × \$95.00)	\$ 9,500
Overhead (125 returns × 80% × \$47.50)	4,750
Total	<u>\$14,250</u>

2N87

Answer 4 (cont.)

c. Standard Cost Per Return

Labor (5 hrs. @ \$20)	\$100
Overhead (5 hrs. @ \$10)	50
Total	<u>\$150</u>

d. Analysis of March Performance

- (1) Total labor variance (actual minus standard)
 $\$89,000 - (950^* \times \$100) = \$6,000$ favorable
- (2) Labor rate variance
 $[(\$89,000/4,000) - \$20] \times 4,000 = \$9,000$ unfavorable
- (3) Labor efficiency variance
 $[4,000 - (950^* \times 5)] \times \$20 = \$15,000$ favorable
- (4) Total overhead variance (actual minus standard)
 $\$45,000 - (950^* \times \$50) = \$2,500$ favorable
- (5) Overhead volume variance
 $\$49,000 - (950^* \times \$50) = \$1,500$ unfavorable
- (6) Overhead budget variance
 $\$45,000 - \$49,000 = \$4,000$ favorable

	<u>Labor</u>	<u>Overhead</u>
*Equivalent units (weighted average method)	1,000	1,000
Less equivalent units beginning inventory (25% \times 200)	50	50
Equivalent units for current production	<u>950</u>	<u>950</u>

2N85

Answer 5 (10 points)

a.

Leif Company
Sigma Division

**SCHEDULE OF EXPECTED ANNUAL CONTRIBUTION MARGIN
FOR KACE AT VARIOUS SALES PRICES**

<u>Sales price</u>	<u>Expected sales level (units)</u>	<u>Expected total sales</u>	<u>Expected variable costs at \$3</u>	<u>Expected contribution margin</u>
\$6	83,000 [1]	\$498,000	\$249,000	\$249,000
7	79,000 [2]	553,000	237,000	316,000
8	74,000 [3]	592,000	222,000	370,000

[1] 70,000 × 10% = 7,000	[2] 70,000 × 40% = 28,000	[3] 70,000 × 70% = 49,000
80,000 × 50% = 40,000	80,000 × 30% = 24,000	80,000 × 20% = 16,000
90,000 × 40% = 36,000	90,000 × 30% = 27,000	90,000 × 10% = 9,000
<u>83,000</u>	<u>79,000</u>	<u>74,000</u>

**b. 1. COMPUTATION OF CURRENT PRE-TAX ACCOUNTING RATE OF
RETURN ON INVESTMENT**

Sigma Division's current annual sales	\$2,000,000	
Current pre-tax rate of return on sales	<u>10%</u>	\$200,000
Investment in Sigma Division		600,000
Pre-tax accounting rate of return on investment		33⅓%

**b. 2. COMPUTATION OF EXPECTED PRE-TAX ACCOUNTING RATE
OF RETURN ON IMPLEMENTATION OF RECOMMENDATIONS
BY MANAGER OF SIGMA DIVISION**

Sigma Division's current annual sales	\$2,000,000	
Expected reduction in sales volume (10%)	<u>200,000</u>	
Expected sales volume after discontinuance of Sago	1,800,000	
Expected pre-tax accounting rate of return on sales	<u>12%</u>	\$216,000
Total proposed investment in Sigma Division		700,000
Expected pre-tax accounting rate of return on investment		30.86%

**c. COMPUTATION OF NET PRESENT VALUE OF
INVESTMENT OPPORTUNITY ON PROPOSED LOAN TO COTE CORP.**

Discounted cash flows for year:		
1	.8 × \$ 50,000 =	\$ 40,000
2	.7 × 90,000 =	63,000
3	.6 × 110,000 =	<u>66,000</u>
Total		\$169,000
Proposed loan		<u>200,000</u>
Net present value		<u><u>\$(31,000)</u></u>

This investment will not earn an internal rate of return of 20%.

Accounting Practice

2M85

Answer 4 (10 points)

Mayne Manufacturing Co.
CASH BUDGET
For the Years Ending March 31,

	<u>1986</u>	<u>1987</u>
Balance of cash at beginning	\$ 0	\$ 75,000
Cash generated from operations		
Collections from customers — Schedule A	<u>\$825,000</u>	<u>\$1,065,000</u>
Disbursements		
Direct materials — Schedule B	220,000	245,000
Direct labor	300,000	360,000
Variable overhead	100,000	120,000
Fixed costs	<u>130,000</u>	<u>130,000</u>
Total disbursements	<u>750,000</u>	<u>855,000</u>
Excess of cash collections over cash disbursements from operations	<u>75,000</u>	<u>210,000</u>
Cash available from operations	75,000	285,000
Cash received from liquidation of existing accounts receivable and inventories	<u>90,000</u>	<u>0</u>
Total cash available	165,000	285,000
Payments to general creditors	<u>90,000</u>	<u>270,000</u> [2]
Balance of cash at end	<u>\$ 75,000</u> [1]	<u>\$ 15,000</u> [1]

[1] This amount could have been used to pay general creditors or carried forward to the beginning of the next year.

[2] $(\$600,000 \times 60\%) - (\$50,000 + \$40,000)$

Unofficial Answers

Schedule A

Mayne Manufacturing Co.
COLLECTIONS FROM CUSTOMERS
For the Years Ending March 31,

	<u>1986</u>	<u>1987</u>
Sales	\$900,000	\$1,080,000
Beginning accounts receivable	0	75,000
Total	900,000	1,155,000
Less ending accounts receivable	75,000	90,000
Collections from customers	<u>\$825,000</u>	<u>\$1,065,000</u>

Schedule B

Mayne Manufacturing Co.
DISBURSEMENTS FOR DIRECT MATERIALS
For the Years Ending March 31,

	<u>1986</u>	<u>1987</u>
Direct materials required for production	\$200,000	\$240,000
Required ending inventory	40,000[3]	50,000[4]
Total	240,000	290,000
Less beginning inventory	0	40,000
Purchases	240,000	250,000
Beginning accounts payable	0	20,000
Total	240,000	270,000
Less ending accounts payable	20,000	25,000
Disbursements for direct materials	<u>\$220,000</u>	<u>\$245,000</u>

[3] $12,000 \text{ units} \times \frac{2}{12} = 2,000$; $2,000 \times \$20 \text{ per unit} = \$40,000$

[4] $15,000 \text{ units} \times \frac{2}{12} = 2,500$; $2,500 \times \$20 \text{ per unit} = \$50,000$

VIII. Not-for-Profit and Governmental Accounting

2M87

Answer 5 (10 points)

Esperanza Hospital
**WORKSHEET TO ADJUST GENERAL LEDGER BALANCES
AND TO ESTABLISH SEPARATE FUNDS**
January 1, 1987

Account	Trial Balance December 31, 1986		Adjustments		General (Unrestricted) Funds		Endowment Fund		Plant Replacement and Expansion Fund	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Cash	60,000				60,000					
Investment in U.S. Treasury bills	400,000						400,000			
Investment in corporate bonds	500,000								500,000	
Interest receivable	10,000				10,000					
Accounts receivable	50,000				50,000					
Inventory	30,000				30,000					
Land	100,000				40,000					
Building	800,000				800,000					
Equipment	170,000				170,000					
Allowance for depreciation		410,000		336,000(3)		746,000				
Accounts payable		20,000				20,000				
Notes payable		70,000				70,000				
Endowment fund balance		520,000		120,000(1)				400,000		
Other fund balances		1,100,000		1,100,000(6)						

Unofficial Answers

Account	Trial Balance December 31, 1986		Adjustments		General (Unrestricted) Funds		Endowment Fund		Plant Replacement and Expansion Fund	
	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit	Debit	Credit
Due from general (unrestricted) funds			246,000(4)						246,000	
Due to plant replacement and expan- sion fund				246,000(5)		246,000				
Plant replace- ment and expansion fund balance				246,000(4) 500,000(6)						746,000
General (unrestricted) funds balance										
			60,000(2)	120,000(1)						
			336,000(3)	600,000(6)						
			246,000(5)			78,000				
Totals	2,120,000	2,120,000	2,108,000	2,108,000	1,160,000	1,160,000	400,000	400,000	746,000	746,000

Accounting Practice

2M87

Answer 5 (cont.)

Esperanza Hospital
ADJUSTING JOURNAL ENTRIES
January 1, 1987

(Not Required)

	<u>Debit</u>	<u>Credit</u>
(1)		
Endowment fund balance	120,000	
General (unrestricted) funds balance		120,000
To transfer investment income		
(2)		
General (unrestricted) funds balance	60,000	
Land		60,000
To eliminate appreciation in land value		
(3)		
General (unrestricted) funds balance	336,000	
Allowance for depreciation		336,000
To correct allowance for depreciation account as follows:		
Building — $\$720,000 \times 2\% \times 40 \text{ years}$	\$576,000	
Elevator — $80,000 \times 5\% \times 20 \text{ years}$	80,000	
Equipment (correctly computed)	90,000	
Correct allowance for depreciation	<u>746,000</u>	
Balance per books	<u>410,000</u>	
Understatement	<u>\$336,000</u>	
(4)		
Due from general (unrestricted) funds	246,000	
Plant replacement and expansion fund balance		246,000
Adjusted allowance for depreciation	\$746,000	
Investment in corporate bonds	500,000	
Underfunded for asset replacement	<u>\$246,000</u>	
(5)		
General (unrestricted) funds balance	246,000	
Due to plant replacement and expansion fund		246,000
(6)		
Other fund balances	1,100,000	
Plant replacement and expansion fund balance		500,000
General (unrestricted) funds balance		600,000
To allocate other fund balances		

Unofficial Answers

2M86

Answer 5 (10 points)

	<u>Debit</u>	<u>Credit</u>
a. Local government		
[1] <i>General fund</i>		
Expenditures control	\$ 25,000	
Cash		\$ 25,000
<i>General fixed assets account group</i>		
Equipment	25,000	
Investment in general fixed assets from general fund revenues		25,000
[2] <i>General fund</i>		
Cash	100,000	
Revenues control		100,000
[3] <i>Nonexpendable trust (endowment) fund</i>		
Cash	55,000	
Operating revenues control		5,000
Investments		50,000
[4] <i>Capital projects fund</i>		
Cash	1,000,000	
Other financing sources control		1,000,000
Expenditures control	1,000,000	
Cash		1,000,000
<i>General long-term debt account group</i>		
Amount to be provided for retirement of general long-term debt	1,000,000	
General obligation bonds payable		1,000,000
<i>General fixed assets account group</i>		
Buildings	1,000,000	
Investment in general fixed assets from capital projects funds		1,000,000

2M86

Answer 5 (cont.)

	<u>Debit</u>	<u>Credit</u>
b. Voluntary health and welfare organization		
[1] <i>Current unrestricted fund</i>		
Fund balance — undesignated	\$ 25,000	
Cash		\$ 25,000
<i>Plant fund</i>		
Equipment	25,000	
Fund balance — expended		25,000
[2] <i>Current unrestricted fund</i>		
Cash	100,000	
Contributions		100,000
[3] <i>Endowment fund</i>		
Cash	55,000	
Due to current unrestricted		
fund (or investment income)		5,000
Investments		50,000
[4] <i>Plant fund</i>		
Cash	1,000,000	
Bonds payable		1,000,000
Buildings	1,000,000	
Cash		1,000,000

Unofficial Answers

2M85

Answer 5 (10 points)

a.

Community Association for Handicapped Children
STATEMENT OF SUPPORT, REVENUE, AND EXPENSES
AND CHANGES IN FUND BALANCES
FOR CURRENT FUNDS
Year Ended June 30, 1984

	<u>Unrestricted</u>	<u>Restricted</u>	<u>Total</u>
Public support and revenue			
Public support			
Contributions (net of provision for uncollectible unrestricted pledges of \$2,000)	\$298,000	\$15,000	\$313,000
Revenue			
Membership dues	25,000	—	25,000
Program service fees	30,000	—	30,000
Investment income	10,000	—	10,000
Total revenue	65,000	—	65,000
Total public support and revenue	363,000	15,000	378,000
Expenses			
Program services			
Blind children	150,000	—	150,000
Deaf children	120,000	—	120,000
Total program services	270,000	—	270,000
Supporting services			
Management and general	45,000	4,000	49,000
Fund-raising	8,000	1,000	9,000
Total supporting services	53,000	5,000	58,000
Total expenses	323,000	5,000	328,000
Excess of public support and revenue over expenses	40,000	10,000	50,000
Other changes in fund balances			
Transfers of endowment fund income	20,000	—	20,000
Fund balances, July 1, 1983	38,000	3,000	41,000
Fund balances, June 30, 1984	\$ 98,000	\$13,000	\$111,000

Accounting Practice

2M85

Answer 5 (cont.)

b.

Community Association for Handicapped Children
CURRENT FUNDS BALANCE SHEETS
June 30, 1984

<i>Assets</i>		<i>Liabilities and Fund Balances</i>	
		<u><i>Unrestricted</i></u>	
Cash	\$ 40,000	Accounts payable and accrued expenses	\$ 50,000
Investments (at cost, which approximates market)	100,000	Deferred revenue	<u>2,000</u>
Pledges receivable (less allowances for uncollectibles of \$3,000)	9,000	Total liabilities and deferred revenue	<u>52,000</u>
Accrued interest receivable	1,000	Fund balances	
		Designated	12,000
		Undesignated	<u>86,000</u>
		Total fund balances	<u>98,000</u>
Total	<u>\$150,000</u>	Total	<u>\$150,000</u>
		<u><i>Restricted</i></u>	
Cash	\$ 9,000	Accounts payable and accrued expenses	\$ 1,000
Bequest receivable	5,000	Fund balance	<u>13,000</u>
Total	<u>\$ 14,000</u>	Total	<u>\$ 14,000</u>

Unofficial Answers

IX. Federal Taxation—Individuals, Estates, and Trusts

2M87

Answer 4 (10 points)

a.

Ann Ford
**PROJECTED RECEIPTS AND EXPENDITURES
WITH NO EFFECT ON TAXABLE INCOME**
1987

	<u>Receipts</u>	<u>Expenditures</u>
Federal income tax (\$9,000 + \$300 + \$5,000)		\$14,300
FICA tax (\$3,132 + \$215)		3,347
Bequest under husband's will	\$25,000	
Life insurance proceeds on husband's death	15,000	
Food, clothing, household, and miscellaneous		20,000
State inheritance tax		2,100
City and state sales taxes		1,100
Auto license and registration		50
Political contribution		100

b.

Ann Ford
COMPUTATION OF PROJECTED TAXABLE INCOME
1987

Adjusted Gross Income

Salary and commissions — outside salesperson	\$50,000
Salary — part-time teacher	3,000
Dividends	500
Long-term capital gain (\$10,000 less \$6,000)	4,000
Simple trust	12,000
Lottery winnings	2,000
Total	71,500

Itemized Deductions

Taxes	
State income taxes (\$1,800 + \$1,200)	\$3,000
Realty taxes	3,600
Total taxes	6,600
Contribution to church	600
Gambling losses (\$420 + \$480)	900
Employee business expenses (\$5,000 less 2% of \$71,500)	3,570
Total itemized deductions	11,670

<i>Personal Exemptions</i> (\$1,900 × 2)	3,800	15,470
Taxable Income		\$56,030

c.

Ann Ford
**COMPUTATION OF PROJECTED
FEDERAL INCOME TAX OVERPAYMENT**
1987

Tax before prepayments		\$12,421
Prepayments		
Federal income tax withheld	\$9,300	
Estimated tax payments	5,000	
Excess FICA tax	215	14,515
Amount overpaid		\$ 2,094

Accounting Practice

2N86

Answer 5 (10 points)

a.

Alex and Myra Cole TAXABLE INCOME For the Year Ended December 31, 1985

Income

Salary		\$62,000
Nonmonetary remuneration (watch)		1,500
Dividends		
Gross amount	\$ 500	
Exclusion	200	300
Refund of state income tax		110
Capital gain (loss)		
Long-term (\$3,000 minus \$2,000)	1,000	
Short-term (\$700 minus \$900)	(200)	
Excess of long-term capital gain over short-term capital loss	800	
Taxable portion	40%	320
Social security benefits		
Gross amount	9,900	
Taxable portion	50%	4,950
Total Income		69,180

Adjustments to Income

Employee business expenses (travel)		800
Adjusted Gross Income		68,380

Itemized Deductions

Medical and dental expenses		
Doctors	\$3,000	
Dentures	800	
Travel to doctors	100	
Medicare premiums	190	
Total	4,090	
Less: 5% of \$68,380	3,419	671
Taxes		
State income tax	3,349	
Sales taxes	1,100	4,449
Contributions		
United Fund	240	
Other recognized charitable organizations	7,000	7,240
Miscellaneous		
Employee business expenses (education)		400
Total Itemized Deductions		12,760
Less: Zero bracket amount		3,540
Excess of AGI over net itemized deductions		59,160

Exemptions

Alex	2	
Myra	1	
Ben	1	4 × \$1,040
		4,160
Taxable Income		\$55,000

Unofficial Answers

b.

Alex and Myra Cole

COMPUTATION OF FEDERAL INCOME TAX OVERPAYMENT

For the Year Ended December 31, 1985

Tax before credit and payments on account		\$12,957
Political contributions credit		<u>100</u>
Net tax		12,857
Payments on account		
Tax withheld	\$10,000	
Estimated tax	<u>3,000</u>	<u>13,000</u>
Amount overpaid		<u><u>\$ 143</u></u>

X. Federal Taxation — Corporations, Partnerships, and Exempt Organizations

2M89

Answer 4 (10 points)

Elm Corp.

FEDERAL TAXABLE INCOME

For the Year Ended December 31, 1988

Sales (net)	\$5,500,000	[1]
Cost of goods sold	<u>3,900,000</u>	[8]
Gross profit	1,600,000	
Dividends	10,000	
Other income		
From partnership	\$63,000	[5]
Recapture of bad debt reserve	<u>30,000</u>	[10]
	93,000	
Total income	<u>1,703,000</u>	
Compensation of officers	125,000	[9]
Salaries and wages	446,000	[9]
Bad debts	9,000	[10]
Taxes	100,000	[11]
Interest	20,000	[12]
Contributions	89,500	[13]
Depreciation	90,000	[14]
Other deductions	<u>18,000</u>	[15]
Total deductions	<u>897,500</u>	
Taxable income before special deduction	805,500	
Special deduction	<u>7,000</u>	[2]
Taxable income	<u><u>\$ 798,500</u></u>	

EXPLANATIONS AND COMPUTATIONS

- [1] Net sales — no adjustment.
- [2] Dividends — $\$10,000 \times 70\%$ dividends-received deduction = \$7,000.
- [3] Interest — not taxable.
- [4] Gain on sale of stock — offset by share of partnership long-term capital loss. Excess capital loss not deductible.
- [5] Equity in earnings of Luz Partnership — $\$50,000 + \$13,000 = \$63,000$.
- [6] Key-man life insurance proceeds — not taxable.
- [7] Tax refund — not taxable.
- [8] Cost of goods sold — no adjustment.
- [9] Salaries and wages — separate \$125,000 officers' compensation.
- [10] Doubtful accounts — limited to \$9,000 actual bad debts. One-fourth of \$120,000 "reserve" at December 31, 1986 = \$30,000 income.
- [11] Taxes — no adjustment.
- [12] Interest — no adjustment.
- [13] Contributions:

Taxable income	\$798,500
Dividends-received deduction	7,000
Contributions deduction	<u>89,500</u>
Total	<u>895,000</u>
Allowable — 10%	<u><u>\$ 89,500</u></u>
- [14] Depreciation — no adjustment.
- [15] Other — \$30,000 less \$12,000 life insurance premiums = \$18,000.
- [16] Federal income tax — not deductible.

Accounting Practice

2M86

Answer 4 (10 points)

Wolf, Inc.
WORKSHEET TO CONVERT BOOK INCOME TO TAXABLE INCOME
For the Year Ended December 31, 1985

	<i>Per books and GAAP</i>	<i>Increases</i>	<i>Decreases</i>	<i>Per tax return</i>
<u><i>Revenues</i></u>				
Net sales	3,000,000			3,000,000
Equity in earnings of F & W Partnership	60,000		2,000 [a]	58,000
Dividends	8,000		6,800 [b]	1,200
Interest	18,000		3,000 [c]	15,000
Gains on sale of stock	5,000		[d]	5,000
Key-man life insurance proceeds	100,000		100,000 [e]	—
Share of dividends from F & W Partnership		10,000	8,500 [f]	1,500
Net long-term capital loss		3,000	8,000 [d]	(5,000)
Totals	3,191,000	13,000	128,300	3,075,700
<u><i>Costs and expenses</i></u>				
Cost of goods sold	2,000,000			2,000,000
Salaries and wages	500,000			500,000
Doubtful accounts	13,000			13,000
Taxes, other than federal income	62,000		2,000 [g]	60,000
Interest	12,000		1,000 [h]	11,000
Contributions	50,000		11,300 [i]	38,700
Depreciation	60,000	25,000		85,000
Other	40,000		5,000 [j]	35,000
Federal income taxes	120,000		120,000 [k]	—
Totals	2,857,000	25,000	139,300	2,742,700
Net income	334,000	(12,000)	(11,000)	333,000

Unofficial Answers

Explanation of adjustments to convert book income to taxable income:

- | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
|---|------------------------------------|----------|---------------------------------|----------------|----------|-----------------|----------------------|----------------|----------------------------|--|-----------------|---------|-----------------|--------------|-------|-------|--|----------------|---|-------------------------|--|-----------------------|----------------|-------------------------------------|--|----------|-------------|------------|------------------|---------|---------|------------------------------------|---------------|-------|-------------------|-------------------------|-----------|----------------------|---------------|---------------------------------------|-------------------------|
| <p>[a] Decrease in equity in earnings of F & W Partnership:</p> <table border="0" style="margin-left: 40px;"> <tr> <td>Dividends qualifying for exclusion</td> <td style="text-align: right;">\$10,000</td> </tr> <tr> <td>Less net long-term capital loss</td> <td style="text-align: right;"><u>(8,000)</u></td> </tr> <tr> <td>Decrease</td> <td style="text-align: right;"><u>\$ 2,000</u></td> </tr> </table> <p>[b] Dividends-received deduction:</p> <table border="0" style="margin-left: 40px;"> <tr> <td>$\\$8,000 \times .85$</td> <td style="text-align: right;"><u>\$6,800</u></td> </tr> </table> <p>[c] Interest earned on municipal bonds is excludible from taxable income.</p> <p>[d] Capital loss is limited to capital gains.</p> <table border="0" style="margin-left: 40px;"> <tr> <td>Capital gains from sale of</td> <td></td> </tr> <tr> <td> Ral Corp. stock</td> <td style="text-align: right;">\$1,000</td> </tr> <tr> <td> Blu, Inc. stock</td> <td style="text-align: right;"><u>4,000</u></td> </tr> <tr> <td> Total</td> <td style="text-align: right;">5,000</td> </tr> <tr> <td>Share of net long-term capital loss from F & W Partnership</td> <td style="text-align: right;"><u>(8,000)</u></td> </tr> <tr> <td>Amount available for carryback or carryover against capital gains</td> <td style="text-align: right;"><u><u>(\$3,000)</u></u></td> </tr> </table> <p>[e] Proceeds of life insurance policies, if paid by reason of the death of the insured, are excluded from taxable income of the recipient.</p> | Dividends qualifying for exclusion | \$10,000 | Less net long-term capital loss | <u>(8,000)</u> | Decrease | <u>\$ 2,000</u> | $\$8,000 \times .85$ | <u>\$6,800</u> | Capital gains from sale of | | Ral Corp. stock | \$1,000 | Blu, Inc. stock | <u>4,000</u> | Total | 5,000 | Share of net long-term capital loss from F & W Partnership | <u>(8,000)</u> | Amount available for carryback or carryover against capital gains | <u><u>(\$3,000)</u></u> | <p>[f] Dividends-received deduction:</p> <table border="0" style="margin-left: 40px;"> <tr> <td>$\\$10,000 \times .85$</td> <td style="text-align: right;"><u>\$8,500</u></td> </tr> </table> <p>[g] Tax penalty is not an allowable deduction.</p> <p>[h] Interest on debt incurred to carry tax-free obligations is not an allowable deduction.</p> <p>[i] Decrease in deduction for contributions:</p> <table border="0" style="margin-left: 40px;"> <tr> <td colspan="2">Taxable income before contributions</td> </tr> <tr> <td>Revenues</td> <td style="text-align: right;">\$3,075,700</td> </tr> <tr> <td>Deductions</td> <td style="text-align: right;"><u>2,704,000</u></td> </tr> <tr> <td>Balance</td> <td style="text-align: right;">371,700</td> </tr> <tr> <td>Plus dividends-received deductions</td> <td style="text-align: right;"><u>15,300</u></td> </tr> <tr> <td>Total</td> <td style="text-align: right;"><u>\$ 387,000</u></td> </tr> <tr> <td>10% allowable deduction</td> <td style="text-align: right;">\$ 38,700</td> </tr> <tr> <td>Actual contributions</td> <td style="text-align: right;"><u>50,000</u></td> </tr> <tr> <td>Excess not deductible in current year</td> <td style="text-align: right;"><u><u>\$ 11,300</u></u></td> </tr> </table> <p>[j] Life insurance premiums are not allowable as a deduction if the corporation is the beneficiary.</p> <p>[k] Federal income tax expense is not an allowable deduction.</p> | $\$10,000 \times .85$ | <u>\$8,500</u> | Taxable income before contributions | | Revenues | \$3,075,700 | Deductions | <u>2,704,000</u> | Balance | 371,700 | Plus dividends-received deductions | <u>15,300</u> | Total | <u>\$ 387,000</u> | 10% allowable deduction | \$ 38,700 | Actual contributions | <u>50,000</u> | Excess not deductible in current year | <u><u>\$ 11,300</u></u> |
| Dividends qualifying for exclusion | \$10,000 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Less net long-term capital loss | <u>(8,000)</u> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Decrease | <u>\$ 2,000</u> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| $\$8,000 \times .85$ | <u>\$6,800</u> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Capital gains from sale of | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Ral Corp. stock | \$1,000 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Blu, Inc. stock | <u>4,000</u> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Total | 5,000 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Share of net long-term capital loss from F & W Partnership | <u>(8,000)</u> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Amount available for carryback or carryover against capital gains | <u><u>(\$3,000)</u></u> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| $\$10,000 \times .85$ | <u>\$8,500</u> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Taxable income before contributions | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Revenues | \$3,075,700 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Deductions | <u>2,704,000</u> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Balance | 371,700 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Plus dividends-received deductions | <u>15,300</u> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Total | <u>\$ 387,000</u> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| 10% allowable deduction | \$ 38,700 | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Actual contributions | <u>50,000</u> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |
| Excess not deductible in current year | <u><u>\$ 11,300</u></u> | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | | |

Uniform CPA Examination/May 1985 – May 1989

Accounting Theory

**Selected Questions
And Unofficial Answers
Indexed To
Content Specification
Outline**




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MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

B. Conceptual Framework

M89#1. According to the FASB's conceptual framework, comprehensive income includes which of the following?

	<u>Operating income</u>	<u>Investments by owners</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N88#1. According to the FASB's conceptual framework, asset valuation accounts are

- a. Assets.
- b. Neither assets nor liabilities.
- c. Part of stockholders' equity.
- d. Liabilities.

M88#1. According to the FASB's conceptual framework, the calculation of comprehensive income includes which of the following?

	<u>Income from continuing operations</u>	<u>Distributions to owners</u>
a.	No	No
b.	Yes	No
c.	Yes	Yes
d.	No	Yes

M88#2. The FASB's conceptual framework classifies gains and losses based on whether they are related to an entity's major ongoing or central operations. These gains or losses may be classified as

	<u>Nonoperating</u>	<u>Operating</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M87#1. According to the FASB conceptual framework, predictive value is an ingredient of

	<u>Relevance</u>	<u>Reliability</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N86#1. According to the FASB Conceptual Framework, earnings

- a. Are the same as comprehensive income.
- b. Exclude certain gains and losses that are included in comprehensive income.
- c. Include certain gains and losses that are excluded from comprehensive income.
- d. Include certain losses that are excluded from comprehensive income.

N86#2. According to the FASB Conceptual Framework, which of the following relates to both relevance and reliability?

	<u>Consistency</u>	<u>Verifiability</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M86#1. According to Statements of Financial Accounting Concepts, neutrality is an ingredient of

	<u>Relevance</u>	<u>Reliability</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N85#1. Under Statements of Financial Accounting Concepts, which of the following relates to both relevance and reliability?

- a. Timeliness.
- b. Neutrality.
- c. Feedback value.
- d. Consistency.

Accounting Theory

M85#2. Under Statements of Financial Accounting Concepts, comprehensive income includes which of the following?

	<u>Gains</u>	<u>Gross margin</u>
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

M85#1. Under Statement of Financial Accounting Concepts No. 2, representational faithfulness is an ingredient of

	<u>Relevance</u>	<u>Reliability</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

C. Basic Concepts and Accounting Principles

M85#2. Some costs cannot be directly related to particular revenues but are incurred to obtain benefits that are exhausted in the period in which the costs are incurred. An example of such a cost is

- Salespersons' monthly salaries.
- Salespersons' commissions.
- Transportation to customers.
- Prepaid insurance.

E. Consolidated Financial Statements

M88#3. A subsidiary was acquired for cash in a business combination on January 1, 1987. The purchase price exceeded the fair value of identifiable net assets. The acquired company owned equipment with a market value in excess of the carrying amount as of the date of combination. A consolidated balance sheet prepared on December 31, 1987, would

- Report the unamortized portion of the excess of the market value over the carrying amount of the equipment as part of goodwill.
- Report the unamortized portion of the excess of the market value over the carrying amount of the equipment as part of plant and equipment.
- Report the excess of the market value over the carrying amount of the equipment as part of plant and equipment.
- Not report the excess of the market value over the carrying amount of the equipment because it would be expensed as incurred.

N86#3. A subsidiary, acquired for cash in a business combination, owned inventories with a market value different than the book value as of the date of combination. A consolidated balance sheet prepared immediately after the acquisition would include this difference as part of

- Deferred credits.
- Goodwill.
- Inventories.
- Retained earnings.

F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts

M88#4. During a period of inflation in which a liability account balance remains constant, which of the following occurs?

- A purchasing power loss if the item is a non-monetary liability.
- A purchasing power gain if the item is a non-monetary liability.
- A purchasing power loss if the item is a monetary liability.
- A purchasing power gain if the item is a monetary liability.

M87#2. When purchasing power gains or losses are computed, how is each of the following classified?

	<u>Patents</u>	<u>Unamortized premium on bonds payable</u>
a.	Nonmonetary	Monetary
b.	Nonmonetary	Nonmonetary
c.	Monetary	Nonmonetary
d.	Monetary	Monetary

N86#4. When measuring the current cost of inventories in accordance with FASB Statement No. 33, the date of sale is the

	<u>Entry date</u>	<u>Exit date</u>
a.	No	Yes
b.	Yes	Yes
c.	Yes	No
d.	No	No

M86#2. During a period of inflation, an account balance remains constant. With respect to this account, a purchasing power gain will be recognized if the account is a

- Monetary liability.
- Monetary asset.
- Nonmonetary liability.
- Nonmonetary asset.

Selected Questions

N85#4. When computing purchasing power gains or losses, how is each of the following classified?

	<u>Allowance for doubtful accounts</u>	<u>Obligations under warranties</u>
a.	Monetary	Nonmonetary
b.	Monetary	Monetary
c.	Nonmonetary	Monetary
d.	Nonmonetary	Nonmonetary

M85#3. When computing information on a historical cost/constant dollar basis, which of the following is classified as nonmonetary?

- Accumulated depreciation of equipment.
- Advances to unconsolidated subsidiaries.
- Allowance for doubtful accounts.
- Unamortized premium on bonds payable.

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

A. Cash, Marketable Securities, and Investments

N88#2. The amount by which the aggregate cost of a marketable equity securities portfolio exceeds its aggregate market value should be reported as a valuation allowance when the portfolio is included

	<u>As a current asset</u>	<u>In an unclassified balance sheet</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N88#3. A short-term marketable debt security was purchased on September 1, 1987, between interest dates. The next interest payment date was February 1, 1988. Because of a permanent decline in market value, the cost of the debt security substantially exceeded its market value at December 31, 1987. On the balance sheet at December 31, 1987, the debt security should be carried at

- Market value plus the accrued interest paid.
- Market value.
- Cost plus the accrued interest paid.
- Cost.

N88#4. An investor purchased a bond as a long-term investment between interest dates at a premium. At the purchase date, the cash paid to the seller is

- The same as the face amount of the bond.
- The same as the face amount of the bond plus accrued interest.
- More than the face amount of the bond.
- Less than the face amount of the bond.

N88#5. An investor uses the equity method to account for an investment in common stock. After the date of

acquisition, the investment account of the investor would

- Not be affected by its share of the earnings or losses of the investee.
- Not be affected by its share of the earnings of the investee, but be decreased by its share of the losses of the investee.
- Be increased by its share of the earnings of the investee, but **not** be affected by its share of the losses of the investee.
- Be increased by its share of the earnings of the investee, and decreased by its share of the losses of the investee.

M88#5. The amount by which the aggregate market value of a marketable equity securities portfolio exceeds its cost should be accounted for as a valuation allowance when the portfolio is classified as

	<u>Current</u>	<u>Noncurrent</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M88#6. An issuer of bonds is required by its bond indenture agreement to use a sinking fund for the retirement of the bonds. Cash was transferred to the sinking fund. The sinking fund cash was then used to purchase investments. The sinking fund

- Increases when the investments are purchased.
- Decreases when the investments are purchased.
- Increases by revenue earned on the investments.
- Is **not** affected by revenue earned on the investments.

Accounting Theory

M87#5. A marketable equity securities portfolio is included in an unclassified balance sheet. The amount by which the aggregate cost of the marketable equity securities portfolio exceeds its aggregate market value should

- Be reported as a valuation allowance in the asset section of the balance sheet.
- Be reported as a valuation allowance in the liability section of the balance sheet.
- Be reported as an unrealized loss in the income statement.
- Not be reported in the financial statements.

M87#6. When the market value of an investment in debt securities exceeds its carrying amount, how should the asset be reported at the end of the year for each of the following?

	<u>Short-term marketable debt securities</u>	<u>Long-term marketable debt securities</u>
a.	Carrying amount	Market
b.	Carrying amount	Carrying amount
c.	Market	Carrying amount
d.	Market	Market

M87#7. An investor purchased a bond classified as a long-term investment between interest dates at a discount. At the purchase date, the carrying amount of the bond is more than the

	<u>Cash paid to seller</u>	<u>Face amount of bond</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M87#8. The market price of the common stock of an investee company increased during the year. How will the investor's investment account be affected by the increase in market price of that common stock under each of the following accounting methods?

	<u>Cost method</u>	<u>Equity method</u>
a.	No effect	No effect
b.	No effect	Increase
c.	Increase	No effect
d.	Increase	Increase

M86#14. A company has a marketable equity securities portfolio. The aggregate market value exceeds the aggregate cost. This difference should

- Be accounted for as a valuation allowance in the asset section of the balance sheet.
- Be accounted for separately in the shareholders' equity section of the balance sheet.
- Be accounted for as an unrealized gain in the income statement.
- Not be accounted for in the financial statements.

M86#15. An investor uses the cost method to account for investments in common stock. Dividends received in excess of the investor's share of investee's earnings subsequent to the date of investment

- Do **not** affect the investment account.
- Decrease the investment account.
- Increase the investment account.
- Increase the investment revenue account.

M86#4. The valuation allowance for a marketable equity securities portfolio included in current assets should be a component of

- Current liabilities.
- Noncurrent liabilities.
- Noncurrent assets.
- Current assets.

M86#5. An investor purchased a bond as a long-term investment on January 1. Annual interest was received on December 31. The investor's interest income for the year would be highest if the bond was purchased at

- Par.
- Face value.
- A discount.
- A premium.

M86#6. How will the investor's investment account be affected by the investor's share of the earnings of the investee after the date of acquisition under each of the following accounting methods?

	<u>Cost method</u>	<u>Equity method</u>
a.	No effect	Increase
b.	Increase	Increase
c.	Increase	No effect
d.	No effect	No effect

M85#4. The amount by which the aggregate cost of a marketable equity securities portfolio exceeds its market value should be accounted for as a valuation allowance when the portfolio is classified as

	<u>Current</u>	<u>Noncurrent</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M85#5. An investor uses the equity method to account for investments in common stock. The purchase price implies a fair value of the investee's depreciable assets in excess of the investee's net asset carrying values. The investor's amortization of the excess

- Decreases the investment account.
- Decreases the goodwill account.
- Increases the investment revenue account.
- Does **not** affect the investment account.

Selected Questions

B. Receivables and Accruals

M89#2. Which of the following is a method to generate cash from accounts receivable?

	<u>Assignment</u>	<u>Factoring</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M89#3. A note receivable bearing a reasonable interest rate is sold to a bank with recourse. At the date of the discounting transaction, the notes receivable discounted account should be

- Decreased by the proceeds from the discounting transaction.
- Increased by the proceeds from the discounting transaction.
- Increased by the face amount of the note.
- Decreased by the face amount of the note.

M88#7. A note receivable bearing a reasonable interest rate is sold to a bank with recourse. The notes receivable discounted account was appropriately credited. The notes receivable discounted account should be reported as a

- Contra-asset account for the proceeds from the discounting transaction.
- Contra-asset account for the face amount of the note.
- Liability account for the proceeds from the discounting transaction.
- Liability account for the face amount of the note.

M87#3. On July 1, 1986, a company received a one-year note receivable bearing interest at the market rate. The face amount of the note receivable and the entire amount of the interest are due on June 30, 1987. The interest receivable account would show a balance on

- July 1, 1986, but not December 31, 1986.
- December 31, 1986, but not July 1, 1986.
- July 1, 1986, and December 31, 1986.
- Neither July 1, 1986, nor December 31, 1986.

M87#4. When the allowance method of recognizing bad debt expense is used, the allowance for doubtful accounts would decrease when a(an)

- Specific account receivable is collected.
- Account previously written off is collected.
- Account previously written off becomes collectible.
- Specific uncollectible account is written off.

M86#7. A 90-day 15% interest-bearing note receivable is sold to a bank with recourse after being held for 60 days. The proceeds are calculated using an 18% interest rate. The amount credited to notes receivable at the date of the discounting transaction would be

- The same as the cash proceeds.
- Less than the face value of the note.
- The face value of the note.
- The maturity value of the note.

M86#8. When the allowance method of recognizing bad debt expense is used, the entries at the time of collection of a small account previously written off would

- Increase net income.
- Decrease the allowance for doubtful accounts.
- Have no effect on the allowance for doubtful accounts.
- Increase the allowance for doubtful accounts.

N85#3. When the allowance method of recognizing bad debt expense is used, the entry to record the specific write-off of an uncollectible account would decrease

- Net accounts receivable.
- Allowance for doubtful accounts.
- Net income.
- Working capital.

C. Inventories

N88#6. According to the net method, which of the following items should be included in the cost of inventory?

	<u>Freight costs</u>	<u>Purchase discounts not taken</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N88#7. During periods of rising prices, a perpetual inventory system would result in the same dollar amount of ending inventory as a periodic inventory system under which of the following inventory cost flow methods?

	<u>FIFO</u>	<u>LIFO</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

Accounting Theory

N88#8. Under the lower of cost or market method, the replacement cost of an inventory item would be used as the designated market value

- When it is below the net realizable value less the normal profit margin.
- When it is below the net realizable value and above the net realizable value less the normal profit margin.
- When it is above the net realizable value.
- Regardless of net realizable value.

N87#1. A company records inventory at the gross invoice price. Theoretically, how should the following affect the costs in inventory?

	<u>Warehousing costs</u>	<u>Cash discounts available</u>
a.	Increase	Decrease
b.	No effect	Decrease
c.	No effect	No effect
d.	Increase	No effect

N87#2. During periods of rising prices, when the FIFO inventory cost flow method is used, a perpetual inventory system would

- Not be permitted.
- Result in a higher ending inventory than a periodic inventory system.
- Result in the same ending inventory as a periodic inventory system.
- Result in a lower ending inventory than a periodic inventory system.

N87#3. The original cost of an inventory item is above the replacement cost. The replacement cost is above the net realizable value. Under the lower of cost or market method, the inventory item should be reported at its

- Original cost.
- Replacement cost.
- Net realizable value.
- Net realizable value less the normal profit margin.

N86#5. Theoretically, warehousing costs incurred by the consignor before consigned goods are transferred to the consignee should be considered

- An expense by the consignor.
- An expense by the consignee.
- Inventoriable by the consignor.
- Inventoriable by the consignee.

N86#6. The dollar-value LIFO inventory cost flow method involves computations based on

	<u>Inventory pools of similar items</u>	<u>A specific price index for each year</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N86#7. The replacement cost of an inventory item is below the net realizable value and above the net realizable value less the normal profit margin. The original cost of the inventory item is above the replacement cost and below the net realizable value. As a result, under the lower of cost or market method, the inventory item should be valued at the

- Original cost.
- Replacement cost.
- Net realizable value.
- Net realizable value less the normal profit margin.

M86#9. The original cost of an inventory item is above the replacement cost and below the net realizable value. The net realizable value less the normal profit margin is above the replacement cost and the original cost. Using the lower of cost or market method the inventory item should be priced at its

- Original cost.
- Replacement cost.
- Net realizable value.
- Net realizable value less the normal profit margin.

M86#10. Theoretically, cash discounts permitted on purchased raw materials should be

- Added to other income, whether taken or not.
- Added to other income, only if taken.
- Deducted from inventory, whether taken or not.
- Deducted from inventory, only if taken.

M86#11. The weighted average for the year inventory cost flow method is applicable to which of the following inventory systems?

	<u>Periodic</u>	<u>Perpetual</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M85#6. Theoretically, freight costs incurred in the transfer of consigned goods from the consignor to the consignee should be considered

- An expense by the consignee.
- An expense by the consignor.
- Inventoriable by the consignee.
- Inventoriable by the consignor.

M85#7. When the double extension approach to the dollar value LIFO inventory cost flow method is used, the inventory layer added in the current year is multiplied by an index number. How would the following be used in the calculation of this index number?

	<u>Ending inventory at current year cost</u>	<u>Ending inventory at base year cost</u>
a.	Numerator	Denominator
b.	Numerator	Not Used
c.	Denominator	Numerator
d.	Not Used	Denominator

Selected Questions

M85#8. The original cost of an inventory item is above the replacement cost and above the net realizable value. The replacement cost is below the net realizable value less the normal profit margin. Under the lower of cost or market method the inventory item should be priced at its

- Original cost.
- Replacement cost.
- Net realizable value.
- Net realizable value less the normal profit margin.

D. Property, Plant, and Equipment Owned or Leased

M89#4. A depreciable asset has an estimated 15% salvage value. At the end of its estimated useful life, the accumulated depreciation would equal the original cost of the asset under which of the following depreciation methods?

	<u>Straight-line</u>	<u>Productive output</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M89#5. A lessee incurred costs to construct office space in a leased warehouse. The estimated useful life of the office is ten years. The remaining term of the nonrenewable lease is fifteen years. The costs should be

- Capitalized as leasehold improvements and depreciated over fifteen years.
- Capitalized as leasehold improvements and depreciated over ten years.
- Capitalized as leasehold improvements and expensed in the year in which the lease expires.
- Expensed as incurred.

M88#8. An expenditure to install an improved electrical system is a

	<u>Capital expenditure</u>	<u>Revenue expenditure</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M88#9. A company using the composite depreciation method for its fleet of trucks, cars, and campers retired one of its trucks and received cash from a salvage company. The net carrying amount of these composite asset accounts would be decreased by the

- Cash proceeds received and original cost of the truck.
- Cash proceeds received.

- Original cost of the truck less the cash proceeds.
- Original cost of the truck.

N87#4. A company is constructing an asset for its own use. Construction began in 1985. The asset is being financed entirely with a specific new borrowing. Construction expenditures were made in 1985 and 1986 at the end of each quarter. The total amount of interest cost capitalized in 1986 should be determined by applying the interest rate on the specific new borrowing to the

- Total accumulated expenditures for the asset in 1985 and 1986.
- Average accumulated expenditures for the asset in 1985 and 1986.
- Average expenditures for the asset in 1986.
- Total expenditures for the asset in 1986.

N87#5. A depreciable asset has an estimated 15% salvage value. At the end of its estimated useful life, the accumulated depreciation would equal the original cost of the asset under which of the following depreciation methods?

	<u>Productive output</u>	<u>Sum of the years' digits</u>
a.	Yes	No
b.	No	No
c.	No	Yes
d.	Yes	Yes

N87#6. A lessee incurred costs to construct walkways to improve leased property. The estimated useful life of the walkways is fifteen years. The remaining term of the nonrenewable lease is twenty years. The walkway costs should be

- Capitalized as leasehold improvements and depreciated over twenty years.
- Capitalized as leasehold improvements and depreciated over fifteen years.
- Capitalized as leasehold improvements and expensed in the year in which the lease expires.
- Expensed as incurred.

N87#7. A company using the group depreciation method for its delivery trucks retired one of its delivery trucks after the average service life of the group was reached. Cash proceeds were received from a salvage company. The net carrying amount of these group asset accounts would be decreased by the

- Original cost of the truck.
- Original cost of the truck less the cash proceeds.
- Cash proceeds received.
- Cash proceeds received and original cost of the truck.

N86#8. An expenditure subsequent to acquisition of assembly-line manufacturing equipment benefits future periods. The expenditure should be capitalized if it is a

	<u>Betterment</u>	<u>Rearrangement</u>
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

N86#9. A machine with a four-year estimated useful life and an estimated 15% salvage value was acquired on January 1, 1984. The increase in accumulated depreciation for 1985 using the double-declining-balance method would be

- Original cost \times 85% \times 50%.
- Original cost \times 50%.
- Original cost \times 85% \times 50% \times 50%.
- Original cost \times 50% \times 50%.

N86#10. Theoretically, which of the following costs incurred in connection with a machine purchased for use in a company's manufacturing operations would be capitalized?

	<u>Insurance on machine while in transit</u>	<u>Testing and preparation of machine for use</u>
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

M86#17. An asset is being constructed for an enterprise's own use. The asset has been financed with a specific new borrowing. The interest cost incurred during the construction period as a result of expenditures for the asset is

- Interest expense in the construction period.
- A prepaid asset to be written off over the estimated useful life of the asset.
- A part of the historical cost of acquiring the asset to be written off over the estimated useful life of the asset.
- A part of the historical cost of acquiring the asset to be written off over the term of the borrowing used to finance the construction of the asset.

M86#19. The lessee should amortize the capitalizable cost of the leased asset in a manner consistent with the lessee's normal depreciation policy for owned assets for leases that

	<u>Contain a bargain purchase option</u>	<u>Transfer ownership of the property to the lessee by the end of the lease term</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M86#20. A lessee incurred landscaping costs to improve leased property. The estimated useful life of the landscaping costs is six years. The remaining term of the nonrenewable lease is five years. The landscaping costs should be

- Capitalized as leasehold improvements and depreciated over five years.
- Capitalized as leasehold improvements and depreciated over six years.
- Expensed as incurred and included with rent expense.
- Expensed as incurred but **not** included with rent expense.

M86#21. A company using the composite depreciation method for its fleet of trucks, cars, and campers retired one of its trucks due to damage before the average service life of the composite group was reached. An insurance recovery was received. Net book value of these composite asset accounts would be decreased by the

- Insurance recovery received.
- Insurance recovery received less depreciation on the truck to the date of retirement.
- Original cost of the truck less the insurance recovery received.
- Original cost of the truck.

N85#5. At its inception, the lease term of Lease G is 65% of the estimated remaining economic life of the leased property. This lease contains a bargain purchase option. The lessee should record Lease G as

- Neither an asset **nor** a liability.
- An asset but **not** a liability.
- An asset and a liability.
- An expense.

N85#6. For a lease that transfers ownership of the property to the lessee by the end of the lease term, the lessee should

- Record the minimum lease payment as an expense.
- Amortize the capitalizable cost of the property using the interest method.
- Amortize the capitalizable cost of the property in a manner consistent with the lessee's normal depreciation policy for owned assets except that the period of amortization should be the lease term.
- Amortize the capitalizable cost of the property in a manner consistent with the lessee's normal depreciation policy for owned assets.

M85#9. A donated plant asset for which the fair value has been determined, and for which incidental costs were incurred in acceptance of the asset, should be recorded at an amount equal to its

- Incidental costs incurred.
- Fair value and incidental costs incurred.
- Book value on books of donor and incidental costs incurred.
- Book value on books of donor.

Selected Questions

M85#10. A machine with a four-year estimated useful life and an estimated fifteen-percent salvage value was acquired on January 1, 1982. On December 31, 1984, the accumulated depreciation using the sum of the years' digits method would be

- (Original cost less salvage value) multiplied by $\frac{9}{10}$.
- Original cost multiplied by $\frac{9}{10}$.
- Original cost multiplied by $\frac{9}{10}$ less total salvage value.
- (Original cost less salvage value) multiplied by $\frac{1}{10}$.

M85#11. A company using the group depreciation method for its delivery trucks retired one of its delivery trucks due to damage before the average service life of the group was reached. An insurance recovery was received. The net book value of these group asset accounts would be decreased by the

- Original cost of the truck.
- Original cost of the truck less the insurance recovery received.
- Original cost of the truck less depreciation on the truck to the date of retirement.
- Insurance recovery received.

E. Intangibles and Other Assets

M89#6. Which of the following costs of goodwill should be capitalized and amortized?

	<u>Developing goodwill</u>	<u>Restoring goodwill</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M88#9. Which of the following legal fees should be capitalized?

	<u>Legal fees to obtain a franchise</u>	<u>Legal fees to successfully defend a trademark</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M88#10. Which of the following costs of goodwill should be capitalized and amortized over their estimated useful lives?

	<u>Costs of goodwill from a business combination accounted for as a purchase</u>	<u>Costs of developing goodwill internally</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M87#9. Legal fees incurred by a company in defending its patent rights should be capitalized when the outcome of the litigation is

	<u>Successful</u>	<u>Unsuccessful</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M87#9. The premium on a three-year insurance policy expiring on December 31, 1988, was paid in total on January 1, 1986. The original payment was initially debited to a prepaid asset account. The appropriate journal entry has been recorded on December 31, 1986. The balance in the prepaid asset account on December 31, 1986, should be

- Zero.
- The same as it would have been if the original payment had been debited initially to an expense account.
- The same as the original payment.
- Higher than if the original payment had been debited initially to an expense account.

M86#11. Which of the following costs of internally generated goodwill inherent in a continuing business and related to an enterprise as a whole should be capitalized and then amortized over their estimated useful lives?

	<u>Costs of maintaining goodwill</u>	<u>Costs of restoring goodwill</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M86#12. Legal fees incurred in successfully defending a patent suit should be capitalized when the patent has been

	<u>Internally developed</u>	<u>Purchased from an inventor</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M85#7. Which of the following should be expensed as incurred by the franchisee for a franchise with an estimated useful life of ten years?

- Amount paid to the franchisor for the franchise.
- Periodic payments to a company, other than the franchisor, for that company's franchise.
- Legal fees paid to the franchisee's lawyers to obtain the franchise.
- Periodic payments to the franchisor based on the franchisee's revenues.

Accounting Theory

N85#8. The premium on a three-year insurance policy expiring on December 31, 1985, was paid in total on January 1, 1983. Assuming that the original payment was initially debited to an expense account, and that appropriate adjusting entries have been recorded on December 31, 1983, and 1984, the balance in the prepaid asset account on December 31, 1984, would be

- a. Zero.
- b. Lower than the balance on December 31, 1985.
- c. The same as the original payment.
- d. The same as it would have been if the original payment had been initially debited to a prepaid asset account.

M85#12. On January 1, 1980, an intangible asset with a fifty-year estimated useful life was acquired. On January 1, 1985, a review was made of the estimated useful life, and it was determined that the intangible asset had an estimated useful life of thirty more years. As a result of the review, the amount to be amortized should be

- a. The original cost at January 1, 1980, allocated equally over a thirty-five-year life.
- b. The original cost at January 1, 1980, allocated equally over a fifty-year life.
- c. The unamortized cost on January 1, 1985, allocated equally over a forty-year life.
- d. The unamortized cost on January 1, 1985, allocated equally over a thirty-year life.

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

A. Payables and Accruals

N88#10. At the end of the accounting period, which of the following costs should be accrued?

	<u>Liability for federal unemployment taxes</u>	<u>Wages earned but unpaid</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#11. On September 1, 1986, a company borrowed cash and signed a two-year interest-bearing note on which both the principal and interest are payable on September 1, 1988. How many months of accrued interest would be included in the liability for accrued interest at December 31, 1986, and December 31, 1987?

	<u>At December 31, 1986</u>	<u>At December 31, 1987</u>
a.	4 months	16 months
b.	4 months	4 months
c.	12 months	24 months
d.	20 months	8 months

M87#10. A company borrowed cash from a bank and issued to the bank a short term noninterest-bearing note payable. The bank discounted the note at 10% and remitted the proceeds to the company. The effective interest rate paid by the company in this transaction would be

- a. Equal to the stated discount rate of 10%.
- b. More than the stated discount rate of 10%.

- c. Less than the stated discount rate of 10%.
- d. Independent of the stated discount rate of 10%.

M87#11. Which of the following is classified as an accrued liability?

	<u>Liability for federal unemployment taxes</u>	<u>Liability for employer's share of FICA taxes</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N86#16. Which of the following is generally associated with payables classified as accounts payable?

	<u>Periodic payment of interest</u>	<u>Secured by collateral</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M86#13. A returnable cash deposit should be classified by the company as a liability when the deposit is received from

	<u>A customer</u>	<u>An employee</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

Selected Questions

M85#14. Which of the following is classified as an accrued payroll liability?

	<u>Federal income tax withheld</u>	<u>Employee's share of FICA taxes</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M85#15. On October 1, 1982, a company borrowed cash and signed a three-year interest-bearing note on which both the principal and interest are payable on October 1, 1985. At December 31, 1984, accrued interest should

- Be reported on the balance sheet as a current liability.
- Be reported on the balance sheet as a non-current liability.
- Be reported on the balance sheet as part of long-term notes payable.
- Not be reported on the balance sheet as a liability.

B. Deferred Revenues

N88#11. According to the installment method of accounting, the gross profit on an installment sale is recognized in income

- On the date of sale.
- On the date the final cash collection is received.
- After cash collections equal to the cost of sales have been received.
- In proportion to the cash collections received.

M88#12. A retail store received cash and issued a gift certificate that is redeemable in merchandise. When the gift certificate was issued, a

- Deferred revenue account should be decreased.
- Deferred revenue account should be increased.
- Revenue account should be decreased.
- Revenue account should be increased.

N87#10. In a sale-leaseback transaction, the seller-lessee retains the right to substantially all of the remaining use of the equipment sold. The profit on the sale should be deferred and subsequently amortized by the lessee when the lease is classified as a(an)

	<u>Capital lease</u>	<u>Operating lease</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M87#12. A retail store received cash and issued gift certificates that are redeemable in merchandise. The gift certificates lapse one year after they are issued. How would the deferred revenue account be affected by each of the following transactions?

	<u>Redemption of certificates</u>	<u>Lapse of certificates</u>
a.	No effect	Decrease
b.	Decrease	Decrease
c.	Decrease	No effect
d.	No effect	No effect

N85#9. Magazine subscriptions collected in advance are reported as

- A contra account to magazine subscriptions receivable in the asset section of the balance sheet.
- Deferred revenue in the liability section of the balance sheet.
- Deferred revenue in the stockholders' equity section of the balance sheet.
- Magazine subscription revenue in the income statement in the period collected.

C. Deferred Income Tax Liabilities

In November 1987, the FASB issued *Statement of Financial Accounting Standards No. 96*, "Accounting for Income Taxes," superseding *APB Opinion No. 11*, "Accounting for Income Taxes." Accordingly, all previous examination items covered by *APB Opinion No. 11* have been deleted.

D. Capitalized Lease Liability

N88#13. A six-year capital lease expiring on December 31 specifies equal minimum annual lease payments. Part of this payment represents interest and part represents a reduction in the net lease liability. The portion of the minimum lease payment in the fifth year applicable to the reduction of the net lease liability should be

- Less than in the fourth year.
- More than in the fourth year.
- The same as in the sixth year.
- More than in the sixth year.

N87#11. For a capital lease, the amount recorded initially by the lessee as a liability should

- Exceed the present value at the beginning of the lease term of minimum lease payments during the lease term.
- Exceed the total of the minimum lease payments during the lease term.
- Not exceed the fair value of the leased property at the inception of the lease.
- Equal the total of the minimum lease payments during the lease term.

Accounting Theory

M87#13. A six-year capital lease specifies equal minimum annual lease payments. Part of this payment represents interest and part represents a reduction in the net lease liability. The portion of the minimum lease payment in the fourth year applicable to the reduction of the net lease liability should be

- a. The same as in the third year.
- b. Less than in the third year.
- c. Less than in the fifth year.
- d. More than in the fifth year.

M87#14. Lease Y does not contain a bargain purchase option, but the lease term is equal to 90 percent of the estimated economic life of the leased property. Lease Z does not transfer ownership of the property to the lessee by the end of the lease term, but the lease term is equal to 75 percent of the estimated economic life of the leased property. How should the lessee classify these leases?

	<u>Lease Y</u>	<u>Lease Z</u>
a.	Capital lease	Operating lease
b.	Capital lease	Capital lease
c.	Operating lease	Capital lease
d.	Operating lease	Operating lease

M86#26. Lease Y contains a bargain purchase option and the lease term is equal to 75 percent of the estimated economic life of the leased property. Lease Z contains a bargain purchase option and the lease term is equal to less than 75 percent of the estimated economic life of the leased property. How should the lessee classify these leases?

	<u>Lease Y</u>	<u>Lease Z</u>
a.	Operating lease	Operating lease
b.	Operating lease	Capital lease
c.	Capital lease	Capital lease
d.	Capital lease	Operating lease

M86#27. A six-year capital lease entered into on December 31, 1984, specified equal minimum annual lease payments due on December 31 of each year. The December 31, 1985, minimum annual lease payment consists of which of the following?

	<u>Interest expense</u>	<u>Lease liability</u>
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

N85#11. The lessee's balance sheet liability for a capital lease would be periodically reduced by the total

- a. Minimum lease payment plus the amortization of the related asset.
- b. Minimum lease payment less the amortization of the related asset.
- c. Minimum lease payment less the portion of the minimum lease payment allocable to interest.
- d. Minimum lease payment.

E. Bonds Payable

N88#14. The issue price of a bond is equal to the present value of the future cash flows for interest and principal when the bond is issued

	<u>At par</u>	<u>At a discount</u>	<u>At a premium</u>
a.	Yes	No	Yes
b.	Yes	No	No
c.	No	Yes	Yes
d.	Yes	Yes	Yes

N88#15. A company issued ten-year term bonds at a discount in 1986. Bond issue costs were incurred at that time. The company uses the effective interest method to amortize bond issue costs. Reporting the bond issue costs as a deferred charge would result in

- a. More of a reduction in net income in 1987 than reporting the bond issue costs as a reduction of the related debt liability.
- b. The same reduction in net income in 1987 as reporting the bond issue costs as a reduction of the related debt liability.
- c. Less of a reduction in net income in 1987 than reporting the bond issue costs as a reduction of the related debt liability.
- d. No reduction in net income in 1987.

N88#16. A ten-year term bond was issued in 1985 at a discount with a call provision to retire the bonds. When the bond issuer exercised the call provision on an interest date in 1987, the carrying amount of the bond was less than the call price. The amount of bond liability removed from the accounts in 1987 should have equaled the

- a. Call price.
- b. Call price less unamortized discount.
- c. Face amount less unamortized discount.
- d. Face amount plus unamortized discount.

M88#14. A five-year term bond was issued by a company on January 1, 1986, at a discount. The carrying amount of the bond at December 31, 1987, would be

- a. Higher than the carrying amount at December 31, 1986.
- b. Lower than the carrying amount at December 31, 1986.
- c. The same as the carrying amount at January 1, 1986.
- d. Higher than the carrying amount at December 31, 1988.

M88#15. At the time of conversion of bonds into common stock, the market value of the stock exceeds the net carrying amount of the bonds. A loss on conversion would be recognized when using the

	<u>Book value method</u>	<u>Market value method</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

Selected Questions

M88#16. When bonds are issued with stock purchase warrants, a portion of the proceeds should be allocated to paid-in capital for bonds issued with

	<u>Detachable stock purchase warrants</u>	<u>Nondetachable stock purchase warrants</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M87#16. The market price of a bond issued at a discount is the present value of its principal amount at the market (effective) rate of interest

- Plus the present value of all future interest payments at the market (effective) rate of interest.
- Plus the present value of all future interest payments at the rate of interest stated on the bond.
- Less the present value of all future interest payments at the market (effective) rate of interest.
- Less the present value of all future interest payments at the rate of interest stated on the bond.

M87#17. A five-year term bond was issued by a company on January 1, 1985, at a premium. The carrying amount of the bond at December 31, 1986, would be

- The same as the carrying amount at January 1, 1985.
- Higher than the carrying amount at December 31, 1985.
- Lower than the carrying amount at December 31, 1987.
- Lower than the carrying amount at December 31, 1985.

M87#18. The proceeds from a bond issued with detachable stock purchase warrants should be accounted for

- Entirely as bonds payable.
- Entirely as stockholders' equity.
- Partially as unearned revenue, and partially as bonds payable.
- Partially as stockholders' equity, and partially as bonds payable.

M86#17. For a bond issue which sells for less than its par value, the market rate of interest is

- Dependent on rate stated on the bond.
- Equal to rate stated on the bond.
- Less than rate stated on the bond.
- Higher than rate stated on the bond.

N86#18. How would the carrying value of a bond payable be affected by amortization of each of the following?

	<u>Discount</u>	<u>Premium</u>
a.	No effect	No effect
b.	Increase	No effect
c.	Increase	Decrease
d.	Decrease	Increase

N86#19. Outstanding bonds payable are converted into common stock. Under either the book value or market value method, the same amount would be debited to

	<u>Bonds payable</u>	<u>Premium on bonds payable</u>
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

N85#12. Theoretically, the proceeds from the sale of a bond will be equal to

- The sum of the face amount of the bond and the periodic interest payments.
- The face amount of the bond.
- The face amount of the bond plus the present value of the interest payments made during the life of the bond discounted at the prevailing market rate of interest.
- The present value of the principal amount due at the end of the life of the bond plus the present value of the interest payments made during the life of the bond, each discounted at the prevailing market rate of interest.

N85#13. When outstanding bonds are converted into common stock, the carrying value of the bonds payable would be removed from the accounts when using the

	<u>Book value method</u>	<u>Market value method</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N85#15. A 10-year bond was issued in 1982 at a premium with a call provision to retire the bonds. When the bond issuer exercised the call provision on an interest date in 1985, the call price exceeded the carrying value of the bonds. The amount of bond liability removed from the accounts in 1985 should have equaled the

- Cash paid.
- Face amount plus unamortized premium.
- Call price plus unamortized premium.
- Current market price.

Accounting Theory

F. Contingent Liabilities and Commitments

M89#7. A manufacturer of household appliances has potential costs due to the discovery of a possible defect in one of its products. The occurrence of the loss is reasonably possible and the costs can be reasonably estimated. This possible loss should be

	<u>Accrued</u>	<u>Disclosed in footnotes</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M88#17. A lawsuit in connection with a safety hazard exists for a manufactured product. Occurrence of a loss is probable and the amount can be reasonably estimated. This loss contingency should be

	<u>Accrued</u>	<u>Disclosed in footnotes</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M87#19. A safety hazard exists for a manufactured product. Occurrence of the loss is reasonably possible and the amount of the loss can be reasonably estimated. This loss contingency should be

	<u>Accrued</u>	<u>Disclosed</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M86#28. Which of the following contingencies should generally be accrued on the balance sheet as a liability when the occurrence of the contingent event is reasonably possible and its amount can be reasonably estimated?

	<u>Expropriation of assets</u>	<u>Product warranty obligation</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N85#19. Which of the following contingencies should generally be accrued on the balance sheet when the occurrence of the contingent event is reasonably possible and its amount can be reasonably estimated?

	<u>Gain contingency</u>	<u>Loss contingency</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M85#16. An expropriation of assets which is imminent and for which the amount of loss can be reasonably estimated should be

	<u>Accrued</u>	<u>Disclosed</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

Selected Questions

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

A. Preferred and Common Stock

M89#8. The number of common stock shares outstanding would be decreased by the

	<u>Declaration of a stock dividend</u>	<u>Purchase of treasury stock</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N88#17. On December 1, 1987, shares of authorized common stock were issued on a subscription basis at a price in excess of par value. A total of 20% of the subscription price of each share was collected as a down payment on December 1, 1987, with the remaining 80% of the subscription price of each share due in 1988. Collectibility was reasonably assured. At December 31, 1987, the stockholders' equity section of the balance sheet would report additional paid-in capital for the excess of the subscription price over the par value of the shares of common stock subscribed and

- Common stock issued for 20% of the par value of the shares of common stock subscribed.
- Common stock issued for the par value of the shares of common stock subscribed.
- Common stock subscribed for 80% of the par value of the shares of common stock subscribed.
- Common stock subscribed for the par value of the shares of common stock subscribed.

N86#20. The issuance of shares of preferred stock to shareholders

- Increases preferred stock outstanding.
- Has **no** effect on preferred stock outstanding.
- Increases preferred stock authorized.
- Decreases preferred stock authorized.

M85#19. The purchase of treasury stock

- Decreases common stock authorized.
- Decreases common stock issued.
- Decreases common stock outstanding.
- Has **no** effect on common stock outstanding.

B. Additional Paid-in Capital

M88#18. When collectibility is reasonably assured, the excess of the subscription price over the stated value of the no par common stock subscribed should be recorded as

- Additional paid-in capital when the common stock is issued.

- Additional paid-in capital when the subscription is collected.
- Additional paid-in capital when the subscription is recorded.
- No par common stock.

M86#29. On February 1, 1986, authorized common stock was sold on a subscription basis at a price in excess of par value, and 20% of the subscription price was collected. On May 1, 1986, the remaining 80% of the subscription price was collected. Additional paid-in capital would increase on

	<u>February 1, 1986</u>	<u>May 1, 1986</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

C. Retained Earnings and Dividends

N88#18. How would a stock split in which the par value per share decreases in proportion to the number of additional shares issued affect each of the following?

	<u>Additional paid-in capital</u>	<u>Retained earnings</u>
a.	Increase	No effect
b.	No effect	No effect
c.	No effect	Decrease
d.	Increase	Decrease

M88#19. A property dividend should be recorded in retained earnings at the property's

- Book value at date of declaration.
- Book value at date of issuance (payment).
- Market value at date of declaration.
- Market value at date of issuance (payment).

N87#14. A company changes from an accounting principle that is not generally accepted to one that is generally accepted. The effect of the change should be reported, net of applicable income taxes, in the current

- Income statement after income from continuing operations and before extraordinary items.
- Income statement after extraordinary items.
- Retained earnings statement as an adjustment of the opening balance.
- Retained earnings statement after net income but before dividends.

Accounting Theory

M87#15. How would the declaration of a liquidating dividend by a corporation affect each of the following?

	<u>Contributed capital</u>	<u>Total stockholders' equity</u>
a.	No effect	Decrease
b.	Decrease	Decrease
c.	Decrease	No effect
d.	No effect	No effect

M87#20. A company declared a cash dividend on its common stock in December 1986, payable in January 1987. Retained earnings would

- Increase on the date of declaration.
- Not be affected on the date of declaration.
- Not be affected on the date of payment.
- Decrease on the date of payment.

M87#21. How would retained earnings be affected by the declaration of each of the following?

	<u>Stock dividend</u>	<u>Stock split</u>
a.	Decrease	Decrease
b.	No effect	Decrease
c.	No effect	No effect
d.	Decrease	No effect

M86#21. The correction of an error in the financial statements of a prior period should be reflected, net of applicable income taxes, in the current

- Income statement after income from continuing operations and before extraordinary items.
- Income statement after income from continuing operations and after extraordinary items.
- Retained earnings statement as an adjustment of the opening balance.
- Retained earnings statement after net income but before dividends.

M86#22. How would total stockholders' equity be affected by the declaration of each of the following?

	<u>Stock dividend</u>	<u>Stock split</u>
a.	No effect	Increase
b.	Decrease	Decrease
c.	Decrease	No effect
d.	No effect	No effect

M86#14. When a property dividend is declared and the book value of the property exceeds its market value, the dividend is recorded at the

- Market value of the property at the date of distribution.
- Market value of the property at the date of declaration.
- Book value of the property at the date of declaration.
- Book value of the property at the date of distribution if it still exceeds the market value of the property at the date of declaration.

M86#15. How would the declaration of a 10% stock dividend by a corporation affect each of the following on its books?

	<u>Retained earnings</u>	<u>Total stockholders' equity</u>
a.	Decrease	No effect
b.	Decrease	Decrease
c.	No effect	Decrease
d.	No effect	No effect

M85#17. How would a stock split affect each of the following?

	<u>Assets</u>	<u>Total stockholders' equity</u>	<u>Additional paid-in capital</u>
a.	Increase	Increase	No effect
b.	No effect	No effect	No effect
c.	No effect	No effect	Increase
d.	Decrease	Decrease	Decrease

D. Treasury Stock and Other Contra Accounts

M89#10. The par-value method of accounting for treasury stock differs from the cost method in that

- Any gain is recognized upon repurchase of stock but a loss is treated as an adjustment to retained earnings.
- No gains or losses are recognized on the issuance of treasury stock using the par-value method.
- It reverses the original entry to issue the common stock with any difference between carrying value and purchase price adjusted through paid-in capital and/or retained earnings and treats a subsequent reissuance like a new issuance of common stock.
- It reverses the original entry to issue the common stock with any difference between carrying value and purchase price being shown as an ordinary gain or loss and does **not** recognize any gain or loss on a subsequent resale of the stock.

M88#19. Treasury stock was acquired for cash at a price in excess of its par value. The treasury stock was subsequently reissued for cash at a price in excess of its acquisition price. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect of the subsequent reissuance of the treasury stock on each of the following?

	<u>Additional paid-in capital</u>	<u>Retained earnings</u>	<u>Total stockholders' equity</u>
a.	Decrease	Decrease	No effect
b.	Increase	Increase	Increase
c.	Increase	No effect	Increase
d.	No effect	No effect	No effect

Selected Questions

M88#20. Treasury stock was acquired for cash at a price in excess of its original issue price. The treasury stock was subsequently reissued for cash at a price in excess of its acquisition price. Assuming that the par value method of accounting for treasury stock transactions is used, what is the effect on total stockholders' equity?

	<u>Acquisition of treasury stock</u>	<u>Reissuance of treasury stock</u>
a.	No effect	No effect
b.	Increase	Decrease
c.	Decrease	No effect
d.	Decrease	Increase

N87#12. Treasury stock was acquired for cash at a price in excess of its par value. The treasury stock was subsequently reissued for cash at a price in excess of its acquisition price. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect on retained earnings?

	<u>Acquisition of treasury stock</u>	<u>Reissuance of treasury stock</u>
a.	No effect	Increase
b.	No effect	No effect
c.	Increase	Decrease
d.	Decrease	Increase

M87#33. Five thousand (5,000) shares of common stock with a par value of \$10 per share were issued initially at \$12 per share. Subsequently, one thousand (1,000) of these shares were acquired as treasury stock at \$15 per share. Assuming that the par value method of accounting for treasury stock transactions is used, what is the effect of the acquisition of the treasury stock on each of the following?

	<u>Additional paid-in capital</u>	<u>Retained earnings</u>
a.	Increase	No effect
b.	Increase	Decrease
c.	Decrease	Increase
d.	Decrease	Decrease

N86#23. Treasury stock was acquired for cash at a price in excess of its par value. The treasury stock was subsequently sold for cash at a price in excess of its acquisition price. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect on total stockholders' equity?

	<u>Purchase of treasury stock</u>	<u>Sale of treasury stock</u>
a.	Increase	Decrease
b.	Decrease	No effect
c.	Decrease	Increase
d.	No effect	No effect

M86#31. Treasury stock was acquired for cash at more than its par value, and then subsequently sold for cash at more than its acquisition price. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect of the subsequent sale of the treasury stock on each of the following?

	<u>Additional paid-in capital</u>	<u>Retained earnings</u>
a.	Increase	Increase
b.	Increase	No effect
c.	No effect	No effect
d.	No effect	Increase

M85#18. Ten thousand shares of \$20 par value common stock were initially issued at \$25 per share. Subsequently, two thousand of these shares were purchased as treasury stock at \$30 per share. Assuming that the cost method of accounting for treasury stock transactions is used, what is the effect of the purchase of the treasury stock on the amount reported in the balance sheet for each of the following?

	<u>Additional paid-in capital</u>	<u>Retained earnings</u>
a.	No effect	No effect
b.	No effect	Decrease
c.	Decrease	No effect
d.	Decrease	Decrease

E. Stock Options, Warrants, and Rights

M89#11. A company issued rights to its existing shareholders without consideration. The rights allowed the recipients to purchase unissued common stock for an amount in excess of par value. When the rights are issued, which of the following will be increased?

	<u>Common stock</u>	<u>Additional paid-in capital</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#20. A company issued rights to its existing shareholders. The rights were issued without consideration. The rights allowed the recipients to purchase unissued common stock for an amount in excess of par value. Common stock will be increased when the

	<u>Rights are issued</u>	<u>Rights lapse</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

Accounting Theory

M88#21. A company issued rights to its existing shareholders. The rights were issued without consideration. The rights allowed the recipients to purchase unissued common stock for an amount in excess of par value. Additional paid-in capital will be

- Increased when the rights are exercised.
- Increased when the rights are issued.
- Decreased when the rights are exercised.
- Decreased when the rights expire.

N87#19. A company issued for no consideration rights to its existing shareholders to purchase, for \$30 per share, unissued shares of \$15 par value common stock. The common stock account will be

- Credited when the rights are exercised.
- Credited when the rights are issued.
- Debited when the rights are exercised.
- Debited when the rights lapse.

M87#34. A company issued rights to its existing shareholders to purchase, for \$30 per share, unissued shares of \$15 par value common stock. Additional paid-in capital will be credited when the

	<u>Rights are issued</u>	<u>Rights lapse</u>
a.	Yes	No
b.	No	No
c.	No	Yes
d.	Yes	Yes

N86#26. A company issued rights to its existing shareholders to purchase shares of common stock. When the rights are exercised, additional paid-in capital would be credited if the purchase price

- Exceeded the par value.
- Was the same as the par value.
- Was the same as the par value, but less than the market value at the date of exercise.
- Was less than the par value.

M85#13. A company issued rights to its existing shareholders to purchase, for \$30 per share, unissued shares of \$15 par value common stock. When the rights lapse

- No entry will be made.
- Additional paid-in capital will be debited.
- Additional paid-in capital will be credited.
- Stock rights outstanding will be debited.

G. Partnerships

M89#12. The Low and Rhu partnership agreement provides special compensation to Low for managing the business. Low receives a bonus of 15 percent of partnership net income before salary and bonus, and also receives a salary of \$45,000. Any remaining profit or loss is to be allocated equally. During 1988, the partnership had net income of \$50,000 before the bonus

and salary allowance. As a result of these distributions, Rhu's equity in the partnership would

- Increase.
- Not change.
- Decrease the same as Low's.
- Decrease.

N88#21. The partnership of Metcalf, Petersen, and Russell shared profits and losses equally. When Metcalf withdrew from the partnership, the partners agreed that there was unrecorded goodwill in the partnership. Under the bonus method, the capital balances of Petersen and Russell were

- Not affected.
- Each reduced by one half of the total amount of the unrecorded goodwill.
- Each reduced by one third of the total amount of the unrecorded goodwill.
- Each reduced by one half of Metcalf's share of the total amount of the unrecorded goodwill.

M88#22. A partnership is formed by two individuals who were previously sole proprietors. Which of the following parts of the initial investment in the newly created partnership would be recorded at the fair value at the date of the investment?

	<u>Marketable securities</u>	<u>Inventories</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N87#13. The partnership agreement for the partnership of Somer and Primrose provided for interest on each partner's average capital investment. Somer's average capital investment was more than Primrose's average capital investment. Profit in excess of interest was allocated equally. If during the year the partnership had profits in excess of the interest on each partner's average capital investment, the amount of Somer's partnership capital would

- Increase the same as Primrose's.
- Increase more than Primrose's.
- Decrease the same as Primrose's.
- Decrease more than Primrose's.

M87#35. When Dubke retired from the partnership of Dubke, Logan and Flaherty, the final settlement of Dubke's partnership interest exceeded Dubke's capital balance. Under the bonus method, the excess

- Was recorded as goodwill.
- Was recorded as an expense.
- Had no effect on the capital balances of Logan and Flaherty.
- Reduced the capital balances of Logan and Flaherty.

Selected Questions

M86#32. A partnership is formed by two individuals who were previously sole proprietors. Property other than cash which is part of the initial investment in the partnership would be recorded for financial accounting purposes at the

- a. Proprietors' book values or the fair value of the property at the date of the investment, whichever is higher.

- b. Proprietors' book values or the fair value of the property at the date of the investment, whichever is lower.
- c. Proprietors' book values of the property at the date of the investment.
- d. Fair value of the property at the date of the investment.

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

A. Revenues and Gains

M89#13. A company uses the completed-contract method to account for a four-year construction contract which is presently in its third year. Progress billings were recorded and collected in the third year. Based on events occurring in the third year, there is now an anticipated loss on the contract. When would the effect of each of the following be reported in the company's income statement?

	<u>Third year progress billings</u>	<u>Anticipated loss</u>
a.	Not third year	Third year
b.	Not third year	Fourth year
c.	Third year	Third year
d.	Third year	Fourth year

M89#14. According to the cost recovery method of accounting, gross profit on an installment sale is recognized in income

- a. After cash collections equal to the cost of sales have been received.
- b. In proportion to the cash collections.
- c. On the date the final cash collection is received.
- d. On the date of sale.

M89#15. An investor uses the equity method to account for an investment in common stock. The investor's equity in the earnings of the investee would be affected by

	<u>Cash dividends from investee</u>	<u>A change in market value of the investee's common stock</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M89#16. Under a royalty agreement with another enterprise, a company will receive royalties from the assignment of a patent for four years. The royalties received in advance should be reported as revenue

- a. In the period received.

- b. In the period earned.
- c. Evenly over the life of the royalty agreement.
- d. At the date of the royalty agreement.

N88#22. A company uses the percentage-of-completion method to account for a four-year construction contract. Which of the following would be used in the calculation of the income recognized in the first year?

	<u>Progress billings</u>	<u>Collections on progress billings</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#23. An investor uses the cost method to account for an investment in common stock. A portion of the dividends received this year were in excess of the investor's share of investee's earnings subsequent to the date of investment. The amount of dividend revenue that should be reported in the investor's income statement for this year would be

- a. Zero.
- b. The total amount of dividends received this year.
- c. The portion of the dividends received this year that were in excess of the investor's share of investee's earnings subsequent to the date of investment.
- d. The portion of the dividends received this year that were **not** in excess of the investor's share of investee's earnings subsequent to the date of investment.

N88#24. Rent should be reported by the lessor as revenue over the lease term as it becomes receivable according to the provisions of the lease for a

	<u>Direct-financing lease</u>	<u>Operating lease</u>	<u>Sales-type lease</u>
a.	Yes	Yes	Yes
b.	Yes	No	No
c.	No	Yes	No
d.	No	No	Yes

Accounting Theory

N88#25. A December 15, 1987, purchase of goods was denominated in a currency other than the entity's functional currency. The transaction resulted in a payable that was fixed in terms of the amount of foreign currency, and was paid on the settlement date, January 20, 1988. The exchange rates between the functional currency and the currency in which the transaction was denominated changed between the transaction date and December 31, 1987, and again between December 31, 1987, and January 20, 1988. Both exchange rate changes resulted in gains. The amount of the gain that should be included in the 1988 financial statements would be

- a. The gain from December 31, 1987, to January 20, 1988.
- b. The gain from December 15, 1987, to January 20, 1988.
- c. The gain from December 15, 1987, to December 31, 1987.
- d. Zero.

M88#23. A company uses the completed-contract method to account for a long-term construction contract. Revenue is recognized when progress billings are

	<u>Recorded</u>	<u>Collected</u>
a.	No	Yes
b.	Yes	Yes
c.	Yes	No
d.	No	No

M88#24. In a lease that is recorded as a sales-type lease by the lessor, interest revenue

- a. Does **not** arise.
- b. Should be recognized over the period of the lease using the interest method.
- c. Should be recognized over the period of the lease using the straight-line method.
- d. Should be recognized in full as revenue at the lease's inception.

N87#16. When should an anticipated loss on a long-term contract be recognized under the percentage-of-completion method and the completed-contract method, respectively?

	<u>Percentage-of-Completion</u>	<u>Completed-Contract</u>
a.	Over life of project	Contract complete
b.	Immediately	Contract complete
c.	Over life of project	Immediately
d.	Immediately	Immediately

N87#17. A foreign subsidiary's functional currency is its local currency, which has not experienced significant inflation. The weighted average exchange rate for the current year would be the appropriate exchange rate for translating

	<u>Wage expense</u>	<u>Sales to customers</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N87#18. The effect of a material transaction that is infrequent in occurrence but **not** unusual in nature should be presented separately as a component of income from continuing operations when the transaction results in a

	<u>Gain</u>	<u>Loss</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M87#26. A company uses the percentage-of-completion method to account for a four-year construction contract. Progress billings sent in the second year that were collected in the third year would

- a. Not be included in the calculation of the income recognized in the second, third, or fourth year.
- b. Be included in the calculation of the income recognized in the second year.
- c. Be included in the calculation of the income recognized in the third year.
- d. Be included in the calculation of the income recognized in the fourth year.

M87#27. A lease is recorded as a sales-type lease by the lessor. The difference between the gross investment in the lease and the sum of the present values of the two components of the gross investment (the net receivable) should be

- a. Amortized over the period of the lease as interest revenue using the interest method.
- b. Amortized over the period of the lease as interest revenue using the straight-line method.
- c. Recognized in full as interest revenue at the lease's inception.
- d. Recognized in full as manufacturer's or dealer's profit at the lease's inception.

N86#24. A sale of goods, denominated in a currency other than the entity's functional currency, resulted in a receivable that was fixed in terms of the amount of foreign currency that would be received. Exchange rates between the functional currency and the currency in which the transaction was denominated changed. The resulting gain should be included as a

- a. Translation gain reported as a separate component of stockholders' equity.
- b. Translation gain reported as a component of income from continuing operations.

Selected Questions

- c. Transaction gain reported as a separate component of stockholders' equity.
- d. Transaction gain reported as a component of income from continuing operations.

M86#33. In a lease that is recorded as a sales-type lease by the lessor, unearned interest

- a. Does **not** arise.
- b. Should be recognized in full as income at the lease's inception.
- c. Should be amortized over the period of the lease using the interest method.
- d. Should be amortized over the period of the lease using the straight-line method.

M85#20. Realized gains from the sale of marketable equity securities should be included in net income of the period of sale when the marketable equity securities portfolio of which they are a part is classified as

	<u>Current</u>	<u>Noncurrent</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M85#21. Gains resulting from the process of translating a foreign entity's financial statements from the functional currency, which has **not** experienced significant inflation, to U.S. dollars should be included as a (an)

- a. Separate component of stockholders' equity.
- b. Deferred credit.
- c. Component of income from continuing operations.
- d. Extraordinary item.

M85#21. A company used the percentage-of-completion method to account for a four-year construction contract. Which of the following would be used in the calculation of the income recognized in the second year?

	<u>Income previously recognized</u>	<u>Progress billings to date</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M85#32. The calculation of the income recognized in the second year of a four-year construction contract which is accounted for using the percentage-of-completion method is based on the

- a. Cumulative actual costs incurred only.
- b. Incremental cost for the second year only.
- c. Latest available estimated costs.
- d. Estimated costs at the inception of the contract.

B. Expenses and Losses

M89#17. A machine with a four-year estimated useful life and an estimated 10% salvage value was acquired on January 1, 1986. The depreciation expense for 1988 using the double-declining-balance method would be original cost multiplied by

- a. $90\% \times 50\% \times 50\% \times 50\%$.
- b. $50\% \times 50\% \times 50\%$.
- c. $90\% \times 50\% \times 50\%$.
- d. $50\% \times 50\%$.

M89#18. A sale of goods was denominated in a currency other than the entity's functional currency. The sale resulted in a receivable that was fixed in terms of the amount of foreign currency that would be received. The exchange rate between the functional currency and the currency in which the transaction was denominated changed. The effect of the change should be included as a

- a. Separate component of stockholders' equity whether the change results in a gain or a loss.
- b. Separate component of stockholders' equity if the change results in a gain, and as a component of income if the change results in a loss.
- c. Component of income if the change results in a gain, and as a separate component of stockholders' equity if the change results in a loss.
- d. Component of income whether the change results in a gain or a loss.

M89#19. A company uses the allowance method to recognize uncollectible accounts expense. What is the effect at the time of the collection of an account previously written off on each of the following accounts?

	<u>Allowance for uncollectible accounts</u>	<u>Uncollectible accounts expense</u>
a.	No effect	Decrease
b.	Increase	Decrease
c.	Increase	No effect
d.	No effect	No effect

M89#20. Which of the following components should be included in net pension cost by an employer sponsoring a defined benefit pension plan?

	<u>Amortization of unrecognized prior service cost</u>	<u>Fair value of plan assets</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

Accounting Theory

M89#21. The effect of a material transaction that is unusual in nature but **not** infrequent in occurrence should be presented separately as a component of income from continuing operations when the transaction results in a

	<u>Gain</u>	<u>Loss</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N88#26. In a periodic inventory system that uses the weighted average cost flow method, the beginning inventory is the

- Net purchases minus the ending inventory.
- Net purchases minus the cost of goods sold.
- Total goods available for sale minus the net purchases.
- Total goods available for sale minus the cost of goods sold.

N88#27. A research and development activity for which the cost would be expensed as incurred is

- Engineering follow-through in an early phase of commercial production.
- Design, construction, and testing of preproduction prototypes and models.
- Trouble-shooting in connection with breakdowns during commercial production.
- Periodic design changes to existing products.

N88#28. A company received royalties from the assignment of patents to other enterprises. In the period in which the royalties are earned, the royalties should be

- Subtracted from the capitalizable cost of the patent.
- Amortized to income over the remaining useful life of the patent.
- Netted against patent amortization expense.
- Reported as revenue.

N88#29. Which of the following components should be included in the calculation of net pension cost recognized for a period by an employer sponsoring a defined benefit pension plan?

	<u>Interest cost</u>	<u>Actual return on plan assets</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#25. Depreciation is computed on the original cost less estimated salvage value under which of the following depreciation methods?

	<u>Double-declining balance</u>	<u>Productive output</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M88#26. A sale of goods was denominated in a currency other than the entity's functional currency. The sale resulted in a receivable that was fixed in terms of the amount of foreign currency that would be received. Exchange rates between the functional currency and the currency in which the transaction was denominated changed so that a loss was incurred. This loss should be included as a

- Translation loss reported as a component of income from continuing operations.
- Translation loss reported as a separate component of stockholders' equity.
- Transaction loss reported as a component of income from continuing operations.
- Transaction loss reported as a separate component of stockholders' equity.

N87#20. A research and development activity for which the cost would be expensed as incurred is

- Modification of the design of a product.
- Trouble-shooting in connection with breakdowns during commercial production.
- Routine design of tools.
- Engineering follow-through in an early phase of commercial production.

N87#21. An employer offered for a short period of time special termination benefits to some employees. The employees accepted the offer, which provided for immediate lump-sum payments and future payments at the end of the next two years. The amounts can be reasonably estimated. The amount of expense recognized this year should include

- One third of the lump-sum payments and one third of the present value of the future payments.
- Only the lump-sum payments.
- The lump-sum payments and the total of the future payments.
- The lump-sum payments and the present value of the future payments.

M87#22. When the interest payment dates of a bond are May 1 and November 1, and the bond is issued on June 1, 1986, the amount of interest expense for the year ended December 31, 1986, would be for

- Two months.
- Six months.
- Seven months.
- Eight months.

Selected Questions

M87#23. Which of the following components should be included in the calculation of net pension cost recognized for a period by an employer sponsoring a defined benefit pension plan?

	<u>Actual return on plan assets, if any</u>	<u>Amortization of unrecognized prior service cost, if any</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M87#24. A December 15, 1986, purchase of goods was denominated in a currency other than the entity's functional currency. The transaction resulted in a payable that was fixed in terms of the amount of foreign currency, and was paid on the settlement date, January 20, 1987. The exchange rates between the functional currency and the currency in which the transaction was denominated changed at December 31, 1986, resulting in a loss that should

- Not be reported until January 20, 1987, the settlement date.
- Be included as a separate component of stockholders' equity at December 31, 1986.
- Be included as a deferred charge at December 31, 1986.
- Be included as a component of income from continuing operations for 1986.

M87#25. A material loss should be presented separately as a component of income from continuing operations when it is

- Infrequent in occurrence and unusual in nature.
- Infrequent in occurrence but **not** unusual in nature.
- A cumulative effect-type change in accounting principle.
- An extraordinary item.

N86#27. Which of the following utilizes the straight-line depreciation method?

	<u>Composite depreciation</u>	<u>Group depreciation</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M86#34. A purchase of goods, denominated in a currency other than the entity's functional currency, resulted in a payable that was fixed in terms of the amount of foreign currency that would be paid. Exchange rates between the functional currency and the currency in

which the transaction was denominated changed. The resulting loss should be included as a (an)

- Component of income from continuing operations.
- Separate component of stockholders' equity.
- Deferred asset.
- Extraordinary item.

N85#16. An activity that would be expensed currently as research and development costs is the

- Engineering follow-through in an early phase of commercial production.
- Conceptual formulation and design of possible product or process alternatives.
- Adaptation of an existing capability to a particular requirement or customer's need as part of a continuing commercial activity.
- Trouble-shooting in connection with breakdowns during commercial production.

N85#17. When the allowance method of recognizing bad debt expense is used, the entries at the time of collection of a small account previously written off would

- Decrease the allowance for doubtful accounts.
- Increase net income.
- Have **no** effect on the allowance for doubtful accounts.
- Have **no** effect on net income.

M85#23. Compensatory stock options were granted to executives on January 1, 1983, with a measurement date of June 30, 1984, for services to be rendered during 1983, 1984, and 1985. The excess of the market value of the stock over the option price at the measurement date was reasonably estimable at the date of grant. The stock options were exercised on April 30, 1985. Compensation expense should be recognized in the income statement in which of the following years?

	<u>1983</u>	<u>1984</u>	<u>1985</u>
a.	No	No	Yes
b.	No	Yes	Yes
c.	Yes	Yes	Yes
d.	Yes	No	No

C. Provision for Income Tax

M89#22. Temporary differences arise when revenues are taxable

	<u>After they are recognized in financial income</u>	<u>Before they are recognized in financial income</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

Accounting Theory

D. Recurring Versus Nonrecurring Transactions and Events

M89#23. An extraordinary item should be reported separately on the income statement as a component of income

	<i>Before discontinued operations of a segment of a business</i>	<i>Net of income taxes</i>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N88#31. When a segment of a business has been discontinued during the year, the loss on disposal should

- Exclude operating losses of the current period up to the measurement date.
- Exclude operating losses during the phase-out period.
- Be an extraordinary item.
- Be an operating item.

M88#28. A gain or loss from a transaction that is unusual in nature and infrequent in occurrence should be reported separately as a component of income

- Before cumulative effect of accounting changes and after discontinued operations of a segment of a business.
- After cumulative effect of accounting changes and after discontinued operations of a segment of a business.
- Before cumulative effect of accounting changes and before discontinued operations of a segment of a business.
- After cumulative effect of accounting changes and before discontinued operations of a segment of a business.

N87#24. A segment of a business has been discontinued during the year. The loss on disposal should

- Include operating losses of the current period up to the measurement date.
- Include employee relocation costs associated with the decision to dispose.
- Exclude severance pay associated with the decision to dispose.
- Exclude operating losses during the phase-out period.

N86#31. When a segment of a business has been discontinued during the year, the loss on disposal should

- Include operating losses of the current period up to the measurement date.
- Include operating losses during the phase-out period.
- Exclude employee relocation costs associated with the decision to dispose.
- Exclude severance pay associated with the decision to dispose.

M85#24. When a segment of a business has been discontinued during the year, this segment's operating losses of the current period up to the measurement date should be included in the

- Income statement as part of the income (loss) from operations of the discontinued segment.
- Income statement as part of the loss on disposal of the discontinued segment.
- Income statement as part of the income (loss) from continuing operations.
- Retained earnings statement as a direct decrease in retained earnings.

E. Accounting Changes

M89#24. The cumulative effect of changing to a new accounting principle should be recorded separately as a component of income after continuing operations for a change from the

- Straight-line method of depreciation for previously recorded assets to the sum-of-the-years'-digits method.
- LIFO method of inventory pricing to the FIFO method.
- Percentage-of-completion method of accounting for long-term construction-type contracts to the completed-contract method.
- Cash basis of accounting for vacation pay to the accrual basis.

N88#32. The cumulative effect of changing to a new accounting principle on the amount of retained earnings at the beginning of the period in which the change is made should be included in net income of

	<i>Future periods</i>	<i>The period of change</i>
a.	No	No
b.	Yes	No
c.	Yes	Yes
d.	No	Yes

N87#23. The cumulative effect on prior years' earnings of a change in accounting principle should be reported separately as a component of income after income from continuing operations, for a change from

- Completed-contract method of accounting for long-term construction-type contracts to the percentage-of-completion method.
- Percentage-of-completion method of accounting for long-term construction-type contracts to the completed-contract method.
- FIFO method of inventory pricing to the weighted-average method.
- LIFO method of inventory pricing to the weighted-average method.

N85#23. The cumulative effect of a change in accounting principle on the amount of retained earnings at the beginning of the period in which the change is made should be reported separately as a component of

Selected Questions

income after continuing operations for a change from the

- a. Double-declining-balance method of depreciation for previously recorded assets to the straight-line method.
- b. LIFO method of inventory pricing to the FIFO method.
- c. Completed-contract method of accounting for long-term construction-type contracts to the percentage-of-completion method.
- d. Percentage-of-completion method of accounting for long-term construction-type contracts to the completed-contract method.

F. Earnings Per Share

M89#25. Antidilutive stock options would generally be used in the calculation of

	<u>Primary earnings per share</u>	<u>Fully diluted earnings per share</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#33. Dilutive stock options would generally be used in the calculation of

	<u>Primary earnings per share</u>	<u>Fully diluted earnings per share</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M88#29. Earnings per share data should be reported on the face of the income statement for

	<u>Income before extraordinary items</u>	<u>Cumulative effect of a change in accounting principle</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N87#33. The if-converted method of computing earnings per share data assumes conversion of convertible securities as of the

- a. Beginning of the earliest period reported (or at time of issuance, if later).
- b. Beginning of the earliest period reported (regardless of time of issuance).

- c. Middle of the earliest period reported (regardless of time of issuance).
- d. Ending of the earliest period reported (regardless of time of issuance).

M87#32. In determining primary earnings per share, a common stock equivalent was antidilutive in 1985 and dilutive in 1986. The common stock equivalent would be included in the computation for

	<u>1985</u>	<u>1986</u>
a.	Yes	Yes
b.	No	Yes
c.	No	No
d.	Yes	No

N86#32. In determining earnings per share in a complex capital structure, which of the following is a common stock equivalent?

	<u>Nonconvertible preferred stock</u>	<u>Stock option</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M86#16. When computing fully diluted earnings per share, convertible securities that are not common stock equivalents are

- a. Recognized only if they are dilutive.
- b. Recognized only if they are anti-dilutive.
- c. Recognized whether they are dilutive or anti-dilutive.
- d. Ignored.

N85#25. In computing earnings per share, a method of recognizing the use of proceeds that would be obtained upon exercise of options and warrants is the

- a. Antidilution method.
- b. Common stock equivalents method.
- c. Treasury stock method.
- d. If-converted method.

M85#25. Antidilutive common stock equivalents would generally be used in the calculation of

	<u>Primary earnings per share</u>	<u>Fully diluted earnings per share</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

VI. Other Financial Topics

A. Statement of Cash Flows

M89#26. In a statement of cash flows, receipts from sales of property, plant, and equipment and other productive assets should generally be classified as cash inflows from

- Operating activities.
- Financing activities.
- Investing activities.
- Selling activities.

M89#27. In a statement of cash flows, interest payments to lenders and other creditors should be classified as cash outflows for

- Operating activities.
- Borrowing activities.
- Lending activities.
- Financing activities.

B. Accounting Policies

M89#28. Which of the following should be disclosed in the summary of significant accounting policies?

	<u>Composition of inventories</u>	<u>Maturity dates of long-term debt</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M88#32. Which of the following should be disclosed in the summary of significant accounting policies?

	<u>Composition of plant assets</u>	<u>Inventory pricing</u>
a.	Yes	Yes
b.	No	Yes
c.	No	No
d.	Yes	No

N87#25. Which of the following should be disclosed in the summary of significant accounting policies?

	<u>Composition of inventories</u>	<u>Depreciation expense</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M86#36. Which of the following facts concerning inventories should be disclosed in the Summary of Significant Accounting Policies?

CompositionPricing

	<u>Composition</u>	<u>Pricing</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N85#30. Which of the following should be disclosed in the Summary of Significant Accounting Policies?

Basis of
consolidationComposition
of plant assets

	<u>Basis of consolidation</u>	<u>Composition of plant assets</u>
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

C. Accounting Changes

M89#29. A change in the periods benefitted by a deferred cost because additional information has been obtained is

- A correction of an error.
- An accounting change that should be reported by restating the financial statements of all prior periods presented.
- An accounting change that should be reported in the period of change and future periods if the change affects both.
- Not an accounting change.

N87#26. The effect of a change in accounting principle which is inseparable from the effect of a change in accounting estimate should be reported

- In the period of change and future periods if the change affects both.
- By restating the financial statements of all prior periods presented.
- By showing the pro forma effects of retroactive application.
- As a correction of an error.

N86#36. Pro forma effects on net income and earnings per share of retroactive application would usually be reported on the face of the income statement for a

Change in
accounting
entityChange in
accounting
estimate

	<u>Change in accounting entity</u>	<u>Change in accounting estimate</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

Selected Questions

M85#28. When a company changes from the straight-line method of depreciation for previously recorded assets to the double-declining-balance method, which of the following should be reported?

	<u>Cumulative effect of change in accounting principle</u>	<u>Pro forma effects of retroactive application</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

D. Nonmonetary Transactions

N88#36. An entity disposes of a nonmonetary asset in a nonreciprocal transfer. A gain or loss should be recognized on the disposition of the asset when the fair value of the asset transferred is determinable and the nonreciprocal transfer is to

	<u>Another entity</u>	<u>A stockholder of the entity</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M88#33. Company S and Company T exchanged nonmonetary assets. The exchange did not culminate an earning process for either Company S or Company T. Company S paid cash to Company T in connection with the exchange. Realized gain on the exchange, to the extent that the amount of cash exceeds a proportionate share of the carrying amount of the asset surrendered, should be recognized by

	<u>Company S</u>	<u>Company T</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N87#27. Company N donated computer equipment to a university (a nonreciprocal transfer). The fair value of the computer equipment was determinable. The difference between the fair value of the nonmonetary asset transferred and its recorded amount at the date of donation should be recognized in Company N's income statement when the difference results in a

	<u>Gain</u>	<u>Loss</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N86#33. Company A and Company B exchanged nonmonetary assets with monetary consideration involved. The exchange did not culminate an earning

process for either Company A or Company B. The recipient of the monetary consideration has

- Realized gain on the exchange to the extent of the monetary consideration received.
- Realized gain on the exchange to the extent that the amount of the monetary consideration received exceeds the recorded amount of the asset surrendered.
- Realized gain on the exchange to the extent that the amount of the monetary consideration received exceeds a proportionate share of the recorded amount of the asset surrendered.
- No realized gain on the exchange.

M86#35. A nonmonetary asset received by Company Y in a nonreciprocal transfer from Company Z should be recorded by Y at

- Z's recorded amount.
- Z's recorded amount or the fair value of the asset received, whichever is higher.
- Z's recorded amount or the fair value of the asset received, whichever is lower.
- The fair value of the asset received.

E. Business Combinations

M89#30. A business combination is accounted for appropriately as a pooling of interests. Registration fees related to effecting the business combination should be

- Deducted directly from retained earnings of the combined corporation.
- Deducted in determining net income of the combined corporation for the period in which the costs were incurred.
- Capitalized and subsequently amortized over a period **not** exceeding forty years.
- Capitalized but **not** subsequently amortized.

M89#31. A business combination is accounted for appropriately as a purchase. Which of the following should be deducted in determining the combined corporation's net income for the current period?

	<u>Direct costs of acquisition</u>	<u>General expenses related to acquisition</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#34. A business combination is accounted for appropriately as a pooling of interests. Costs of furnishing information to stockholders related to effecting the business combination should be

- Capitalized and subsequently amortized over a period **not** exceeding forty years.
- Capitalized but **not** amortized.
- Deducted directly from retained earnings of the combined corporation.
- Deducted in determining net income of the combined corporation for the period in which the costs were incurred.

M88#35. Company L acquired all of the outstanding common stock of Company M in exchange for cash. The acquisition price exceeds the fair value of net assets acquired. How should Company L determine the amounts to be reported for the plant and equipment and long-term debt acquired from Company M?

	<u>Plant and equipment</u>	<u>Long-term debt</u>
a.	Fair value	M's carrying amount
b.	Fair value	Fair value
c.	M's carrying amount	Fair value
d.	M's carrying amount	M's carrying amount

N87#29. A business combination occurs in the middle of the year. Results of operations for the year of combination would include the combined results of operations of the separate companies for the entire year if the business combination is a

	<u>Pooling of interests</u>	<u>Purchase</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N86#34. In a business combination, costs of registering equity securities are a reduction of the otherwise determinable fair value of the securities for a

	<u>Pooling of interests</u>	<u>Purchase</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N85#32. Registration fees related to effecting a business combination should be deducted in determining net income of the combined corporation for the period in which the fees were incurred for a

	<u>Pooling of interests</u>	<u>Purchase</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M85#29. In a business combination accounted for as a purchase, costs of registering equity securities to be issued by the acquiring company are a (an)

- Expense of the combined company for the period in which the costs were incurred.
- Direct addition to stockholders' equity of the combined company.
- Reduction of the otherwise determinable fair value of the securities.
- Addition to goodwill.

F. Interim Financial Statements

M89#32. An inventory loss from a market price decline occurred in the first quarter. The loss was not expected to be restored in the fiscal year. However, in the third quarter the inventory had a market price recovery that exceeded the market decline that occurred in the first quarter. For interim financial reporting, the dollar amount of net inventory should

- Decrease in the first quarter by the amount of the market price decline and increase in the third quarter by the amount of the market price recovery.
- Decrease in the first quarter by the amount of the market price decline and increase in the third quarter by the amount of decrease in the first quarter.
- Not be affected in the first quarter and increase in the third quarter by the amount of the market price recovery that exceeded the amount of the market price decline.
- Not be affected in either the first quarter or the third quarter.

N88#37. For interim financial reporting, which of the following may be accrued or deferred to provide an appropriate cost in each period?

	<u>Interest</u>	<u>Rent</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#36. For interim financial reporting, a company's income tax provision for the second quarter of 1988 should be determined using the

- Statutory tax rate for 1988.
- Effective tax rate expected to be applicable for the full year of 1988 as estimated at the end of the first quarter of 1988.
- Effective tax rate expected to be applicable for the full year of 1988 as estimated at the end of the second quarter of 1988.
- Effective tax rate expected to be applicable for the second quarter of 1988.

N87#30. Rent may be accrued or deferred to provide an appropriate cost in each period for

	<u>Interim financial reporting</u>	<u>Year-end financial reporting</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

Selected Questions

N86#35. For interim financial reporting, which of the following may be accrued or deferred to provide an appropriate cost in each period?

	<u>Property taxes</u>	<u>Rent</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M86#37. The accrual or deferral of interest costs to allocate cost to each period is appropriate for

	<u>Interim financial reporting</u>	<u>Year-end financial reporting</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M85#30. Property taxes may be accrued or deferred to provide an appropriate cost in each period for

	<u>Interim financial reporting</u>	<u>Year-end financial reporting</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

G. Gain Contingencies

M89#33. When the occurrence of a gain contingency is reasonably possible and its amount can be reasonably estimated, the gain contingency should be

- Included in net income and disclosed.
- Included as an appropriation of retained earnings.
- Disclosed, but **not** included in net income.
- Neither included in net income nor disclosed.

N87#31. When the occurrence of a gain contingency is probable and its amount can be reasonably estimated, the gain contingency should be

- Recognized in the income statement and disclosed.
- Classified as an appropriation of retained earnings.
- Disclosed, but **not** recognized in the income statement.
- Neither recognized in the income statement nor disclosed.

H. Segments and Lines of Business

M89#34. In financial reporting for segments of a business enterprise, which of the following should be taken

into account in computing the amount of an industry segment's identifiable assets?

	<u>Accumulated depreciation</u>	<u>Marketable securities valuation allowance</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M88#37. In financial reporting for segments of a business enterprise, the revenue of a segment should include

- Intersegment billings for the cost of shared facilities.
- Intersegment sales of services similar to those sold to unaffiliated customers.
- Equity in income from unconsolidated subsidiaries.
- Extraordinary items.

N87#32. In financial reporting for segments of a business enterprise, which of the following should be taken into account in computing the amount of an industry segment's identifiable assets?

	<u>Accumulated depreciation</u>	<u>Allowance for doubtful accounts</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N86#37. In financial reporting for segments of a business enterprise, the operating profit or loss of a manufacturing segment should include

	<u>Interest expense</u>	<u>Income taxes</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N85#33. In financial reporting for segments of a business enterprise, the operating profit or loss of a segment should include

	<u>Expenses related to revenue from intersegment sales</u>	<u>Portion of general corporate expenses</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M85#31. In Logan Company's financial reporting for segments of a business enterprise, which of the following assets should be included as an identifiable asset of the textile mill product industry segment?

- A loan from the textile mill product segment to another industry segment.
- An investment by the textile mill product segment in another industry segment.
- An allocated portion of assets maintained for general corporate purposes and **not** used in the operations of the textile mill product segment.
- An allocated portion of intangible assets used jointly by the textile mill product segment and another industry segment.

I. Employee Benefits

M89#35. An employer sponsoring a defined benefit pension plan should disclose the

	<u>Amount of unrecognized prior service cost</u>	<u>Projected benefit obligation</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M89#36. An employer's obligation relating to employees' rights to receive compensation for future absences is attributable to employees' services already rendered. The payment of compensation is probable and the amount of compensation can be reasonably estimated. Employees' compensation should be

- Accrued if the obligation relates to rights that vest or accumulate.
- Accrued if the obligation relates to rights that do **not** vest or accumulate.
- Expensed when paid.
- Disclosed, but **not** accrued if the obligation relates to rights that vest or accumulate.

N88#38. If the payment of employees' compensation for future absences is probable, the amount can be reasonably estimated, and the obligation relates to rights that vest, the compensation should be

- Recognized when paid.
- Accrued if attributable to employees' services whether already rendered or **not**.
- Accrued if attributable to employees' services already rendered.
- Accrued if attributable to employees' services **not** already rendered.

N87#36. An employer sponsoring a defined benefit pension plan should

- Disclose the projected benefit obligation, identifying the accumulated benefit obligation and the vested benefit obligation.
- Disclose the projected benefit obligation, identifying the accumulated benefit obligation but **not** the vested benefit obligation.

- Disclose the projected benefit obligation, identifying the vested benefit obligation but **not** the accumulated benefit obligation.
- Not disclose the projected benefit obligation.

N87#37. For a compensatory stock option plan for which the date of grant and the measurement date are different, the stock options outstanding account should be reduced at the

- Adoption date of the plan.
- Date of grant.
- Measurement date.
- Exercise date.

M87#39. An employer sponsoring a defined benefit pension plan should disclose the

	<u>Amount of unrecognized prior service cost</u>	<u>Fair value of plan assets</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M85#34. In determining whether to accrue employee's compensation for future absences, among the conditions that must be met are that the obligation relates to rights that

	<u>Accumulate</u>	<u>Vest</u>
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

J. Analysis of Financial Statements

M89#37. Which of the following ratios is(are) useful in assessing a company's ability to meet currently maturing or short-term obligations?

	<u>Acid-test ratio</u>	<u>Debt to equity ratio</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N88#39. Which of the following ratios help users to assess the company's ability to meet currently maturing or short-term obligations?

	<u>Dividend payout ratio</u>	<u>Acid-test ratio</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

Selected Questions

M88#38. Which of the following ratios are useful for evaluating the effectiveness with which the company uses its assets?

	<u><i>Acid test (quick) ratio</i></u>	<u><i>Price earnings ratio</i></u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N87#38. How are trade receivables used in the calculation of each of the following?

	<u><i>Acid test (quick) ratio</i></u>	<u><i>Receivable turnover</i></u>
a.	Denominator	Denominator
b.	Not used	Numerator
c.	Numerator	Numerator
d.	Numerator	Denominator

M87#40. How are dividends per share for common stock used in the calculation of the following?

	<u><i>Dividend per-share payout ratio</i></u>	<u><i>Earnings per share</i></u>
a.	Numerator	Numerator
b.	Numerator	Not used
c.	Denominator	Not used
d.	Denominator	Denominator

N86#39. How are each of the following used in the calculation of the receivable turnover?

	<u><i>Cash sales</i></u>	<u><i>Credit sales</i></u>
a.	Not used	Numerator
b.	Not used	Denominator
c.	Numerator	Numerator
d.	Denominator	Denominator

M86#39. How is the average inventory used in the calculation of each of the following?

	<u><i>Acid test (quick) ratio</i></u>	<u><i>Inventory turnover rate</i></u>
a.	Not used	Denominator
b.	Not used	Numerator
c.	Numerator	Numerator
d.	Numerator	Denominator

K. Development Stage Enterprises

M89#38. A development stage enterprise

a. Issues an income statement that shows only cumulative amounts from the enterprise's inception.

- b. Issues an income statement that is the same as an established operating enterprise, but does **not** show cumulative amounts from the enterprise's inception as additional information.
- c. Issues an income statement that is the same as an established operating enterprise, and shows cumulative amounts from the enterprise's inception as additional information.
- d. Does **not** issue an income statement.

M88#39. A development stage enterprise should use the same generally accepted accounting principles that apply to established operating enterprises for

	<u><i>Capitalization of costs</i></u>	<u><i>Recognition of revenue</i></u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N85#34. A development stage enterprise should include with its financial statements certain additional information. Cumulative amounts from the enterprise's inception is an example of additional information that should be included in its

	<u><i>Income statement</i></u>	<u><i>Statement of changes in financial position</i></u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

L. Personal Financial Statements

M89#39. In a personal statement of financial condition, which of the following should be reported at estimated current values?

	<u><i>Investments in closely held businesses</i></u>	<u><i>Investments in leaseholds</i></u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#40. In a personal statement of financial condition, which of the following should be reported at quoted market prices?

	<u><i>Marketable debt securities</i></u>	<u><i>Marketable equity securities</i></u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

Accounting Theory

M88#40. Personal financial statements should report an investment in life insurance in the statement of financial condition as an

- a. Asset for the cash value of the policy less the amount of any loans against it.
- b. Asset for the cash value of the policy and a liability for the amount of any loans against it.
- c. Asset for the face amount of the policy less the amount of any loans against it.
- d. Asset for the face amount of the policy less the amount of premiums paid.

N87#39. Personal financial statements should include a

	<u>Statement of financial condition</u>	<u>Statement of changes in financial position</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N86#40. Personal financial statements consist of a statement of financial condition and usually a(an)

	<u>Income statement</u>	<u>Statement of changes in net worth</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M85#33. Personal financial statements should present

- a. Assets and liabilities at their historical cost.
- b. Assets at their estimated current values and liabilities at their estimated current amounts at the date of the financial statements.
- c. Assets at their estimated current values at the date of the financial statements and liabilities at their historical cost.
- d. Assets and liabilities at their historical cost and, as additional information, at their estimated current values.

M. Combined Financial Statements

M89#40. Which of the following items should be treated in the same manner in both combined financial statements and consolidated statements?

	<u>Income taxes</u>	<u>Minority interest</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N87#40. When combined financial statements are prepared for a group of related companies, intercompany transactions and intercompany profits or losses should be eliminated when the group is composed of

	<u>Commonly controlled companies</u>	<u>Unconsolidated subsidiaries</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements

M89#41. Direct materials cost is a

	<u>Conversion cost</u>	<u>Prime cost</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N88#41. The fixed portion of the semivariable cost of electricity for a manufacturing plant is a

	<u>Period cost</u>	<u>Product cost</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#41. An example of a direct labor cost is wages paid to a

	<u>Factory machine operator</u>	<u>Supervisor in a factory</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N87#45. Direct materials cost is a

	<u>Period cost</u>	<u>Product cost</u>
a.	Yes	No
b.	No	No
c.	No	Yes
d.	Yes	Yes

Selected Questions

M87#41. In developing a factory overhead application rate for use in a process costing system, which of the following could be used in the denominator?

- a. Estimated direct labor hours.
- b. Actual direct labor hours.
- c. Estimated factory overhead.
- d. Actual factory overhead.

N86#41. Prime cost and conversion cost share what common element of total cost?

- a. Direct labor.
- b. Direct materials.
- c. Variable overhead.
- d. Fixed overhead.

M86#41. Wages paid to a timekeeper in a factory are a

	<u>Prime cost</u>	<u>Conversion cost</u>
a.	Yes	No
b.	Yes	Yes
c.	No	No
d.	No	Yes

N85#36. In developing a factory overhead application rate for use in a process costing system, which of the following could be used in the numerator?

- a. Actual direct labor hours.
- b. Estimated direct labor hours.
- c. Actual factory overhead costs.
- d. Estimated factory overhead costs.

N85#37. The cost of rent for a manufacturing plant is a

	<u>Prime cost</u>	<u>Product cost</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M85#36. The variable portion of the semivariable cost of electricity for a manufacturing plant is a

	<u>Conversion cost</u>	<u>Period cost</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M85#37. The cost of fire insurance for a manufacturing plant is generally a

- a. Nonmanufacturing cost.
- b. Period cost.
- c. Semivariable cost.
- d. Conversion cost.

B. Process and Job Order Costing

M89#42. In a process cost system, the application of factory overhead usually would be recorded as an increase in

- a. Cost of goods sold.
- b. Work in process control.
- c. Factory overhead control.
- d. Finished goods control.

N86#42. The completion of goods is recorded as a decrease in work in process control when using

	<u>Job order costing</u>	<u>Process costing</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#42. In a job order cost system, the use of direct materials previously purchased usually is recorded as an increase in

- a. Work in process control.
- b. Factory overhead control.
- c. Factory overhead applied.
- d. Stores control.

N87#41. In a job order cost system using predetermined factory overhead rates, indirect materials usually are recorded initially as an increase in

- a. Work in process control.
- b. Factory overhead applied.
- c. Factory overhead control.
- d. Stores control.

M87#42. In a job order cost system, direct labor costs usually are recorded initially as an increase in

- a. Factory overhead applied.
- b. Factory overhead control.
- c. Finished goods control.
- d. Work in process control.

N86#42. Costs are accumulated by responsibility center for control purposes when using

	<u>Job order costing</u>	<u>Process costing</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M86#42. In the computation of manufacturing cost per equivalent unit, the weighted-average method of process costing considers

- a. Current costs only.
- b. Current costs plus cost of ending work in process inventory.
- c. Current costs plus cost of beginning work in process inventory.
- d. Current costs less cost of beginning work in process inventory.

Accounting Theory

N85#38. In a job order cost system, the application of factory overhead would usually be reflected in the general ledger as an increase in

- a. Factory overhead control.
- b. Finished goods control.
- c. Work in process control.
- d. Cost of goods sold.

N85#39. Assuming that there was no beginning work in process inventory, and the ending work in process inventory is 50% complete as to conversion costs, the number of equivalent units as to conversion costs would be

- a. The same as the units completed.
- b. The same as the units placed in process.
- c. Less than the units completed.
- d. Less than the units placed in process.

M85#38. In a job order cost system, the use of indirect materials would usually be reflected in the general ledger as an increase in

- a. Stores control.
- b. Work in process control.
- c. Factory overhead control.
- d. Factory overhead applied.

M85#41. When using the first-in, first-out method of process costing, total equivalent units of production for a given period of time is equal to the number of units

- a. In work in process at the beginning of the period times the percent of work necessary to complete the items, plus the number of units started during the period, less the number of units remaining in work in process at the end of the period times the percent of work necessary to complete the items.
- b. In work in process at the beginning of the period, plus the number of units started during the period, plus the number of units remaining in work in process at the end of the period times the percent of work necessary to complete the items.
- c. Started into process during the period, plus the number of units in work in process at the beginning of the period.
- d. Transferred out during the period, plus the number of units remaining in work in process at the end of the period times the percent of work necessary to complete the items.

C. Standard Costing

N88#43. Under the two-variance method for analyzing factory overhead, which of the following is used in the computation of the controllable (budget) variance?

	<u>Budget allowance based on actual hours</u>	<u>Budget allowance based on standard hours</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M88#43. Under the two-variance method for analyzing factory overhead, the actual factory overhead is used in the computation of the

	<u>Controllable (budget) variance</u>	<u>Volume variance</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N87#42. Under the three-variance method for analyzing factory overhead, which of the following is used in the computation of the spending variance?

	<u>Actual factory overhead</u>	<u>Budget allowance based on actual hours</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M87#43. Under the two-variance method for analyzing factory overhead, the factory overhead applied to production is used in the computation of the

	<u>Controllable (budget) variance</u>	<u>Volume variance</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N86#43. Under the two-variance method for analyzing factory overhead, the difference between the actual factory overhead and the budget allowance based on standard hours allowed is the

- a. Net overhead variance.
- b. Efficiency variance.
- c. Volume variance.
- d. Controllable (budget) variance.

M86#43. When using the two-variance method for analyzing factory overhead, the difference between the budget allowance based on standard hours allowed and the factory overhead applied to production is the

- a. Net overhead variance.
- b. Controllable variance.
- c. Volume variance.
- d. Efficiency variance.

N85#40. Under the three-variance method for analyzing factory overhead, which of the following is used in the computation of the spending variance?

	<u>Budget allowance based on standard hours</u>	<u>Factory overhead applied to production</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

Selected Questions

M85#41. Under the two-variance method for analyzing factory overhead, the difference between the actual factory overhead and the factory overhead applied to production is the

- Controllable variance.
- Net overhead variance.
- Efficiency variance.
- Volume variance.

M85#39. Under the three-variance method for analyzing factory overhead, the difference between the actual factory overhead and the factory overhead applied to production is the

- Net overhead variance.
- Controllable variance.
- Efficiency variance.
- Spending variance.

M85#40. Under the two-variance method for analyzing factory overhead, the budget allowance based on standard hours allowed is used in the computation of the

	<u>Controllable (budget) variance</u>	<u>Volume variance</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap

M89#44. Spoilage from a manufacturing process was discovered during an inspection of work in process. In a process costing system, the cost of the spoilage would be added to the cost of the good units produced if the spoilage is

	<u>Abnormal</u>	<u>Normal</u>
a.	No	Yes
b.	No	No
c.	Yes	Yes
d.	Yes	No

M88#44. The sale of scrap from a manufacturing process usually would be recorded as a(an)

- Decrease in factory overhead control.
- Increase in factory overhead control.
- Decrease in finished goods control.
- Increase in finished goods control.

M88#44. In accounting for byproducts, the value of the byproduct may be recognized at the time of

	<u>Production</u>	<u>Sale</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M87#44. For the purposes of cost accumulation, which of the following are identifiable as different individual products before the split-off point?

	<u>By-products</u>	<u>Joint products</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N86#44. By-products could have which of the following characteristics?

	<u>Zero costs beyond split-off</u>	<u>Additional costs beyond split-off</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M86#44. Which of the following is often subject to further processing in order to be salable?

	<u>By-products</u>	<u>Scrap</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M85#50. By-products

- Have relatively more sales value than joint products.
- Have relatively less sales value than scrap.
- Occur before the split-off point.
- Are often subject to additional costs beyond the split-off point.

E. Absorption and Variable Costing

M89#45. In an income statement prepared using the variable costing method, fixed factory overhead would

- Not be used.
- Be used in the computation of the contribution margin.
- Be used in the computation of operating income but not in the computation of the contribution margin.
- Be treated the same as variable factory overhead.

N88#45. In an income statement prepared as an internal report, operating income would normally be measured under

	<u>Absorption costing</u>	<u>Variable costing</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

Accounting Theory

M88#45. In an income statement prepared as an internal report using the variable costing method, variable selling and administrative expenses would

- Not be used.
- Be treated the same as fixed selling and administrative expenses.
- Be used in the computation of operating income but **not** in the computation of the contribution margin.
- Be used in the computation of the contribution margin.

N87#46. In an income statement prepared as an internal report using the variable costing method, which of the following terms should appear?

	<u>Gross profit (margin)</u>	<u>Operating income</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M87#45. In an income statement prepared as an internal report using the absorption costing method, which of the following terms should appear?

	<u>Contribution margin</u>	<u>Gross profit (margin)</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N85#43. The absorption costing method includes in inventory

	<u>Fixed factory overhead</u>	<u>Variable factory overhead</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M85#42. In an income statement prepared as an internal report using the direct (variable) costing method, fixed selling and administrative expenses would

- Not be used.
- Be used in the computation of the contribution margin.
- Be used in the computation of operating income but not in the computation of the contribution margin.
- Be treated the same as variable selling and administrative expenses.

F. Budgeting and Flexible Budgeting

M89#46. A flexible budget is appropriate for a(an)

	<u>Administrative budget</u>	<u>Marketing budget</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N88#46. When a flexible budget is used, an increase in production levels within the relevant range would

- Not change variable costs per unit.
- Not change total variable costs.
- Not change fixed costs per unit.
- Change total fixed costs.

M88#46. The flexible budget for a company may include

	<u>Direct material costs</u>	<u>Variable selling costs</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N87#47. When production levels are expected to decline within a relevant range, and a flexible budget is used, what effects would be anticipated with respect to each of the following?

	<u>Fixed costs per unit</u>	<u>Variable costs per unit</u>
a.	Increase	No change
b.	Increase	Increase
c.	No change	No change
d.	No change	Increase

M87#46. The flexible budget for a producing department may include

	<u>Direct labor</u>	<u>Factory overhead</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M86#46. A flexible budget is appropriate for a (an)

	<u>Administrative budget</u>	<u>Direct material budget</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

Selected Questions

- M85#43.** A flexible budget is
- Not appropriate when costs and expenses are affected by fluctuations in volume limits.
 - Appropriate for any relevant level of activity.
 - Appropriate for control of factory overhead but **not** for control of direct materials and direct labor.
 - Appropriate for control of direct materials and direct labor but **not** for control of factory overhead.

G. Breakeven and Cost-Volume-Profit Analysis

- M89#47.** Breakeven analysis assumes that over the relevant range
- Total costs are unchanged.
 - Unit variable costs are unchanged.
 - Variable costs are nonlinear.
 - Unit fixed costs are unchanged.

- N88#47.** Breakeven analysis assumes that over the relevant range total
- Revenues are linear.
 - Costs are unchanged.
 - Variable costs are nonlinear.
 - Fixed costs are nonlinear.

- M88#47.** Breakeven analysis assumes that over the relevant range
- Variable costs are nonlinear.
 - Fixed costs are nonlinear.
 - Selling prices are unchanged.
 - Total costs are unchanged.

- N87#48.** In using cost-volume-profit analysis to calculate expected unit sales, which of the following should be added to fixed costs in the numerator?
- Predicted operating loss.
 - Predicted operating profit.
 - Unit contribution margin.
 - Variable costs.

- M87#47.** Breakeven analysis assumes over the relevant range that
- Total costs are linear.
 - Fixed costs are nonlinear.
 - Variable costs are nonlinear.
 - Selling prices are nonlinear.

- N86#48.** The contribution margin ratio always increases when the
- Variable costs as a percentage of net sales increase.
 - Variable costs as a percentage of net sales decrease.
 - Breakeven point increases.
 - Breakeven point decreases.

- M86#47.** In using cost-volume-profit analysis to calculate an expected sales level expressed in units, which of the following should be subtracted from fixed costs in the numerator?

- Predicted operating loss.
- Predicted operating profit.
- Unit contribution margin.
- Variable costs.

- M85#44.** How would the following be used in calculating the expected sales level expressed in units?

	<u>Contribution margin per unit</u>	<u>Estimated operating loss</u>
a.	Denominator	Numerator
b.	Numerator	Numerator
c.	Not Used	Denominator
d.	Numerator	Denominator

H. Capital Budgeting Techniques

- M89#48.** The capital budgeting technique known as payback period uses

	<u>Depreciation expense</u>	<u>Time value of money</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

- N88#48.** The capital budgeting technique known as net present value uses

	<u>Cash flow over life of project</u>	<u>Time value of money</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

- M88#48.** The capital budgeting technique known as internal rate of return uses

	<u>Cash flow over entire life of project</u>	<u>Time value of money</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

- N87#49.** The capital budgeting technique known as accounting rate of return uses

	<u>Depreciation expense</u>	<u>Time value of money</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

Accounting Theory

M87#48. A proposed project has an expected economic life of eight years. In the calculation of the net present value of the proposed project, salvage value would be

- Excluded from the calculation of the net present value.
- Included as a cash inflow at the estimated salvage value.
- Included as a cash inflow at the future amount of the estimated salvage value.
- Included as a cash inflow at the present value of the estimated salvage value.

N86#49. If income tax considerations are ignored, how is depreciation expense used in the following capital budgeting techniques?

	<u>Internal rate of return</u>	<u>Net present value</u>
a.	Excluded	Excluded
b.	Excluded	Included
c.	Included	Excluded
d.	Included	Included

M86#48. The net present value capital budgeting technique can be used when cash flows from period to period are

	<u>Uniform</u>	<u>Uneven</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N85#47. The discount rate (hurdle rate of return) must be determined in advance for the

- Internal rate of return method.
- Net present value method.
- Payback period method.
- Time adjusted rate of return method.

N85#48. The payback capital budgeting technique considers

	<u>Income over entire life of project</u>	<u>Time value of money</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M85#45. On May 1, 1985, a company purchased a new machine which it does not have to pay for until May 1, 1987. The total payment on May 1, 1987, will include both principal and interest. Assuming interest at a 10% rate, the cost of the machine would be the total payment multiplied by what time value of money concept?

- Future amount of annuity of 1.
- Future amount of 1.
- Present value of annuity of 1.
- Present value of 1.

M85#46. It is assumed that cash flows are reinvested at the rate earned by the investment in which of the following capital budgeting techniques?

	<u>Internal rate of return</u>	<u>Net present value</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

I. Performance Analysis

M89#49. Residual income is income

- To which an imputed interest charge for invested capital is added.
- From which an imputed interest charge for invested capital is deducted.
- From which dividends are deducted.
- To which dividends are added.

N88#49. The calculation of a company's return on investment is affected by a change in

	<u>Capital turnover</u>	<u>Profit margin on sales</u>
a.	Yes	Yes
b.	No	Yes
c.	No	No
d.	Yes	No

M88#49. A company is analyzing the performance of responsibility centers. Controllable costs would be included in the performance reports of which of the following types of responsibility centers?

	<u>Investment centers</u>	<u>Profit centers</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N87#44. Residual income is the

- Contribution margin of an investment center, less the imputed interest on the invested capital used by the center.
- Contribution margin of an investment center, plus the imputed interest on the invested capital used by the center.
- Income of an investment center, less the imputed interest on the invested capital used by the center.
- Income of an investment center, plus the imputed interest on the invested capital used by the center.

M87#49. A company's rate of return on investment is the

- Percentage of profit to sales divided by the capital-employed turnover rate.
- Percentage of profit to sales multiplied by the capital-employed turnover rate.

Selected Questions

- c. Investment capital divided by the capital-employed turnover rate.
- d. Investment capital multiplied by the capital-employed turnover rate.

N86#47. The invested capital-employed turnover rate would include

- a. Sales in the denominator.
- b. Net income in the numerator.
- c. Invested capital in the denominator.
- d. Invested capital in the numerator.

M86#49. Assuming that sales and net income remain the same, a company's return on investment will

- a. Increase if invested capital increases.
- b. Decrease if invested capital decreases.
- c. Decrease if the invested capital-employed turnover rate decreases.
- d. Decrease if the invested capital-employed turnover rate increases.

M85#47. The invested capital-employed turnover rate would include

- a. Net income in the numerator.
- b. Net income in the denominator.
- c. Sales in the numerator.
- d. Sales in the denominator.

J. Other

M89#50. Which of the following would be included in the economic order quantity formula?

	<u>Inventory carrying cost</u>	<u>Stockout cost</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N88#50. Multiple regression analysis involves the use of

<u>Dependent variables</u>	<u>Independent variables</u>
a. One	More than one
b. More than one	More than one
c. More than one	One
d. One	One

M88#50. In statistical analysis, a weighted average using probabilities as weights is the

- a. Standard deviation.
- b. Expected value.
- c. Coefficient of variation.
- d. Objective function.

N87#50. A company is considering exchanging an old asset for a new asset. Ignoring income tax considerations, which of the following is (are) economically relevant to the decision?

	<u>Carrying amount of old asset</u>	<u>Disposal value of old asset</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M87#50. How would the following be used in the economic order quantity formula?

	<u>Inventory carrying cost</u>	<u>Cost per purchase order</u>
a.	Numerator	Numerator
b.	Denominator	Numerator
c.	Denominator	Denominator
d.	Not used	Denominator

N86#50. Simple regression analysis involves the use of

	<u>Dependent variables</u>	<u>Independent variables</u>
a.	One	None
b.	One	One
c.	One	Two
d.	None	Two

M86#50. In the contribution margin approach to pricing, the price at which the income remains constant is equal to the price that covers

- a. Prime costs.
- b. Variable costs.
- c. Fixed costs.
- d. Fixed and variable costs plus the desired profit.

N85#50. In probability analysis, the square root of the mean of the squared differences between the observed values and the expected value is the

- a. Objective function.
- b. Optimum corner point.
- c. EOQ.
- d. Standard deviation.

M85#48. Multiple regression analysis

- a. Establishes a cause and effect relationship.
- b. Is **not** a sampling technique.
- c. Involves the use of independent variables only.
- d. Produces measures of probable error.

VIII. Not-for-Profit and Governmental Accounting

A. Conceptual Framework

M89#51. Under the modified accrual basis of accounting for a governmental unit, revenues should be recognized in the accounting period in which they

- Are earned and become measurable.
- Are collected.
- Become available and measurable.
- Become available and earned.

N88#51. Which of the following is an appropriate basis of accounting for a proprietary fund of a governmental unit?

	<u>Cash basis</u>	<u>Modified accrual basis</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M88#51. Which of the following is an appropriate basis of accounting for a governmental fund of a governmental unit?

	<u>Accrual basis</u>	<u>Modified accrual basis</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N87#51. Under which basis of accounting for a governmental unit should revenues be recognized in the accounting period in which they become available and measurable?

	<u>Accrual basis</u>	<u>Modified accrual basis</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M86#51. Which of the following is an appropriate basis of accounting for a governmental fund of a governmental unit?

	<u>Cash basis</u>	<u>Modified accrual basis</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N85#51. Under which basis of accounting for a governmental unit should revenues be recognized in the

accounting period in which they are earned and become measurable?

	<u>Accrual basis</u>	<u>Modified accrual basis</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

B. Fund Accounting

M89#52. The encumbrances control account of a governmental unit is increased when

	<u>A voucher payable is recorded</u>	<u>The budgetary accounts are closed</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M89#53. The expenditures control account of a governmental unit is increased when

	<u>A purchase order is approved</u>	<u>The budget is recorded</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

N88#52. The budget of a governmental unit, for which the appropriations exceed the estimated revenues, was adopted and recorded in the general ledger at the beginning of the year. During the year, expenditures and encumbrances were less than appropriations; whereas revenues equaled estimated revenues. The budgetary fund balance account is

- Credited at the beginning of the year and **not** changed at the end of the year.
- Credited at the beginning of the year and debited at the end of the year.
- Debited at the beginning of the year and **not** changed at the end of the year.
- Debited at the beginning of the year and credited at the end of the year.

N88#53. The appropriations control account of a governmental unit is debited when

	<u>The budgetary accounts are closed</u>	<u>Expenditures are recorded</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

Selected Questions

- M88#52.** The fund balance reserved for encumbrances account of a governmental unit is decreased when
- Supplies previously ordered are received.
 - A purchase order is approved.
 - The vouchers are paid.
 - Appropriations are recorded.
- M88#53.** The revenues control account of a governmental unit is increased when
- The budget is recorded.
 - Property taxes are recorded.
 - Appropriations are recorded.
 - The budgetary accounts are closed.
- N87#52.** The estimated revenues control account of a governmental unit is debited when
- The budget is closed at the end of the year.
 - The budget is recorded.
 - Actual revenues are recorded.
 - Actual revenues are collected.
- N87#53.** Which of the following accounts of a governmental unit is debited when a purchase order is approved?
- Appropriations control.
 - Vouchers payable.
 - Fund balance reserved for encumbrances.
 - Encumbrances control.
- M87#52.** The appropriations control account of a governmental unit is credited when
- Supplies are purchased.
 - Expenditures are recorded.
 - The budget is recorded.
 - The budgetary accounts are closed.
- M87#53.** The expenditures control account of a governmental unit is credited when
- The budgetary accounts are closed.
 - The budget is recorded.
 - Supplies are purchased.
 - Supplies previously encumbered are received.
- N86#52.** When the budget of a governmental unit, for which the estimated revenues exceed the appropriations, is adopted and recorded in the general ledger at the beginning of the year, the budgetary fund balance account is
- Credited at the beginning of the year and no entry made at the end of the year.
 - Credited at the beginning of the year and debited at the end of the year.
 - Debited at the beginning of the year and no entry made at the end of the year.
 - Debited at the beginning of the year and credited at the end of the year.
- N86#53.** Which of the following accounts of a governmental unit is debited when supplies previously ordered are received?
- Appropriations control.
 - Encumbrances control.
 - Fund balance reserved for encumbrances.
 - Vouchers payable.
- M86#52.** Which of the following accounts of a governmental unit is credited when supplies previously ordered are received?
- Fund balance reserved for encumbrances.
 - Encumbrances control.
 - Expenditures control.
 - Appropriations control.
- M86#53.** The revenues control account of a governmental unit is debited when
- The budget is recorded at the beginning of the year.
 - The account is closed out at the end of the year.
 - Property taxes are recorded.
 - Property taxes are collected.
- N85#53.** When a truck is received by a governmental unit, the truck should be recorded in the general fund as a debit to a (an)
- Appropriations control.
 - Encumbrances control.
 - Fixed asset.
 - Expenditures control.
- M85#52.** The appropriations control account of a governmental unit is debited when
- The budgetary accounts are closed.
 - The budget is recorded.
 - Supplies are purchased.
 - Expenditures are recorded.
- M85#53.** Which of the following accounts of a governmental unit is credited when a purchase order is approved?
- Encumbrances control.
 - Fund balance reserved for encumbrances.
 - Vouchers payable.
 - Appropriations control.

C. Types of Funds and Account Groups

- M89#54.** Which one of the following funds of a governmental unit is a governmental fund?
- Enterprise funds.
 - Internal service funds.
 - Debt service funds.
 - Nonexpendable trust funds.

M89#55. Fixed assets of an enterprise fund should be accounted for in the

- Enterprise fund but **no** depreciation on the fixed assets should be recorded.
- Enterprise fund and depreciation on the fixed assets should be recorded.
- General fixed asset account group but **no** depreciation on the fixed assets should be recorded.
- General fixed asset account group and depreciation on the fixed assets should be recorded.

M89#56. Unmatured general obligation bonds payable of a governmental unit should be reported in the liability section of the

- General fund.
- Capital projects fund.
- General long-term debt account group.
- Debt service fund.

M89#57. Funds established at a college by donors who have stipulated that the principal is nonexpendable but that the income generated may be expended by current operating funds would be accounted for in the

- Quasi-endowment fund.
- Endowment fund.
- Term endowment fund.
- Agency fund.

N88#54. Which of the following funds of a governmental unit recognizes revenues in the accounting period in which they become available and measurable?

- Capital projects funds.
- Nonexpendable trust funds.
- Enterprise funds.
- Internal service funds.

N88#55. Which of the following funds of a governmental unit would include retained earnings in its balance sheet?

- Expendable pension trust.
- Internal service.
- Special revenue.
- Capital projects.

N88#56. Fixed assets should be accounted for in the general fixed assets account group for the

	<u>Internal service fund</u>	<u>Special revenue fund</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N88#57. Which of the following would appear in the plant fund of a voluntary health and welfare organization?

	<u>Land</u>	<u>Equipment</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#54. Which of the following funds of a governmental unit uses the modified accrual basis of accounting?

- Enterprise funds.
- Internal service funds.
- Nonexpendable trust funds.
- Special revenue funds.

M88#55. Which of the following funds of a governmental unit uses the same basis of accounting as the special revenue fund?

- Expendable trust funds.
- Nonexpendable trust funds.
- Enterprise funds.
- Internal service funds.

M88#56. The amount available in debt service funds is an account of a governmental unit that would be included in the

- Liability section of the general long-term debt account group.
- Liability section of the debt service fund.
- Asset section of the general long-term debt account group.
- Asset section of the debt service fund.

M88#57. Customers' security deposits that cannot be spent for normal operating purposes were collected by a governmental unit and accounted for in the enterprise fund. A portion of the amount collected was invested in marketable securities. How would the portion in cash and the portion in marketable securities be classified in the balance sheet of the enterprise fund?

	<u>Portion in cash</u>	<u>Portion in marketable securities</u>
a.	Restricted asset	Restricted asset
b.	Restricted asset	Unrestricted asset
c.	Unrestricted asset	Unrestricted asset
d.	Unrestricted asset	Restricted asset

N87#54. Which of the following funds of a governmental unit recognizes revenues in the accounting period in which they become available and measurable?

- Nonexpendable trust.
- General.
- Enterprise.
- Internal service.

Selected Questions

N87#55. The debt service fund of a governmental unit is used to account for the accumulation of resources to pay, and the payment of, general long-term debt

	<u>Principal</u>	<u>Interest</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

N87#56. Which of the following funds of a governmental unit uses the same basis of accounting as an enterprise fund?

- a. Special revenue.
- b. Expendable trust.
- c. Capital projects.
- d. Internal service.

N87#57. Which of the following not-for-profit organizations would use plant funds to account for land, buildings, equipment, and other capital assets?

	<u>Colleges and universities</u>	<u>Voluntary health and welfare organizations</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M87#54. Which of the following funds of a governmental unit uses the modified accrual basis of accounting?

- a. Enterprise.
- b. Internal service.
- c. Capital projects.
- d. Nonexpendable trust.

M87#55. Which of the following funds of a governmental unit would account for depreciation in the accounts of the fund?

- a. General.
- b. Internal service.
- c. Capital projects.
- d. Special assessment.

M87#56. Which of the following accounts would be included in the fund equity section of the combined balance sheet of a governmental unit for the general fixed asset account group?

	<u>Investment in general fixed assets</u>	<u>Fund balance reserved for encumbrances</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M87#57. Funds which the governing board of an institution, rather than a donor or other outside agency, has determined are to be retained and invested for other than loan or plant purposes would be accounted for in the

- a. Quasi-endowment fund.
- b. Endowment fund.
- c. Agency fund.
- d. Current fund-restricted.

N86#54. Which of the following funds of a governmental unit integrates budgetary accounts into the accounting system?

- a. Enterprise.
- b. Internal service.
- c. Special revenue.
- d. Nonexpendable trust.

N86#56. The total assets of the general long-term debt account group of a governmental unit consist of the

- a. Amount available in debt service funds account plus the amount to be provided for retirement of general long-term debt account.
- b. Amount available in debt service funds account minus the amount to be provided for retirement of general long-term debt account.
- c. Amount available in debt service funds account only.
- d. Amount to be provided for retirement of general long-term debt account only.

N86#57. How would customers' security deposits which can **not** be spent for normal operating purposes be classified in the balance sheet of the enterprise fund of a governmental unit?

	<u>Restricted asset</u>	<u>Liability</u>	<u>Fund equity</u>
a.	Yes	No	Yes
b.	Yes	Yes	No
c.	Yes	Yes	Yes
d.	No	Yes	No

M86#56. Which type of fund can be either expendable or nonexpendable?

- a. Debt service.
- b. Enterprise.
- c. Special revenue.
- d. Trust.

N85#54. Which of the following funds of a governmental unit uses the modified accrual basis of accounting?

- a. Internal service.
- b. Enterprise.
- c. Nonexpendable trust.
- d. Debt service.

Accounting Theory

M85#55. Proceeds of General Obligation Bonds is an account of a governmental unit that would be included in the

- a. Enterprise fund.
- b. Special assessments fund.
- c. Capital projects fund.
- d. Debt service fund.

M85#56. Which of the following funds of a governmental unit would include contributed capital in its balance sheet?

- a. Expendable pension trust.
- b. Special revenue.
- c. Capital projects.
- d. Internal service.

M85#54. The special revenue fund of a governmental unit is an example of what type of fund?

- a. Governmental.
- b. Proprietary.
- c. Internal service.
- d. Fiduciary.

M85#55. Which governmental fund would account for fixed assets in a manner similar to a "for-profit" organization?

- a. Enterprise.
- b. Capital projects.
- c. General fixed asset account group.
- d. General.

M85#57. Fixed assets should be accounted for in the general fixed assets account group for the

	<u>Capital projects fund</u>	<u>Internal service fund</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

M89#58. The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenues, expenses, and changes in retained earnings for

	<u>Account groups</u>	<u>Proprietary funds</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M88#58. The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenues, expenditures, and changes in fund balances for

	<u>Governmental funds</u>	<u>Proprietary funds</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M88#58. The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenues, expenses, and changes in retained earnings for

	<u>Account groups</u>	<u>Governmental funds</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M87#58. The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenue, expenditures, and changes in fund balances for

	<u>Account groups</u>	<u>Proprietary funds</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M87#58. In the comprehensive annual financial report (CAFR) of a governmental unit, the account groups are included in

- a. Both the combined balance sheet and the combined statement of revenues, expenditures, and changes in fund balances.
- b. The combined statement of revenues, expenditures, and changes in fund balances, but **not** the combined balance sheet.
- c. The combined balance sheet but **not** the combined statement of revenues, expenditures, and changes in fund balances.
- d. Neither the combined balance sheet nor the combined statement of revenues, expenditures, and changes in fund balances.

M86#58. The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of changes in financial position for

	<u>Governmental funds</u>	<u>Account groups</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

Selected Questions

M86#58. The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenues, expenses, and changes in retained earnings for

	<u>Governmental funds</u>	<u>Proprietary funds</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N85#58. The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined statement of revenues, expenditures, and changes in fund balances for

	<u>Governmental funds</u>	<u>Account groups</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M85#58. The comprehensive annual financial report (CAFR) of a governmental unit should contain a combined balance sheet for

	<u>Governmental funds</u>	<u>Proprietary funds</u>	<u>Account groups</u>
a.	Yes	Yes	No
b.	Yes	Yes	Yes
c.	Yes	No	Yes
d.	No	Yes	No

E. Various Types of Not-for-Profit and Governmental Organizations

M89#59. A local governmental unit could have funds using which of the following accounting bases?

	<u>Accrual Basis</u>	<u>Modified accrual basis</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M89#60. Which of the following funds are usually encountered in a not-for-profit private university?

	<u>Loan funds</u>	<u>Life income funds</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N88#59. Proceeds from sale of cafeteria meals and guest trays to visitors operated by a hospital would normally be included in

- a. Patient service revenue.

- b. Ancillary service revenue.
c. Other operating revenue.
d. Other nonoperating revenue.

N88#60. In a statement of support, revenue, and expenses and changes in fund balances of a voluntary health and welfare organization, contributions to the building fund should

- a. Be included as an element of support.
b. Be included as an element of revenue.
c. Be included as an element of other changes in fund balances.
d. Not be included.

M88#59. Which of the following funds are usually encountered in a not-for-profit private university?

	<u>Current funds</u>	<u>Plant funds</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

M88#60. Revenue of a hospital from grants specified by the donor for research would normally be included in

- a. Other nonoperating revenue.
b. Other operating revenue.
c. Patient service revenue.
d. Ancillary service revenue.

N87#59. A local governmental unit could use which of the following types of funds?

	<u>Fiduciary</u>	<u>Proprietary</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N87#60. The current funds group of a not-for-profit private university includes which of the following?

	<u>Agency funds</u>	<u>Plant funds</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

M87#59. Which of the following normally would be included in Other Operating Revenues of a hospital?

	<u>Revenue from educational programs</u>	<u>Unrestricted gifts</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

Accounting Theory

N86#59. The plant funds group of a not-for-profit private university includes which of the following subgroups?

	<u>Investment in plant funds</u>	<u>Unexpanded plant funds</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

N86#60. Revenue from the parking lot operated by a hospital would normally be included in

- Patient service revenue.
- Ancillary service revenue.
- Other operating revenue.
- Other nonoperating revenue.

M86#59. The current funds group of a not-for-profit private university includes which of the following?

	<u>Annuity funds</u>	<u>Loan funds</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M86#60. Securities donated to a voluntary health and welfare organization should be recorded at the

- Donor's recorded amount.
- Fair market value at the date of the gift.
- Fair market value at the date of the gift, or the donor's recorded amount, whichever is lower.
- Fair market value at the date of the gift, or the donor's recorded amount, whichever is higher.

N85#59. A voluntary health and welfare organization received a cash donation in 1983 from a donor specifying that the amount donated be used in 1985. The cash donation should be accounted for as

- Support in 1983.
- Support in 1983, 1984, and 1985, and as a deferred credit in the balance sheet at the end of 1983 and 1984.
- Support in 1985, and no deferred credit in the balance sheet at the end of 1983 and 1984.
- Support in 1985, and as a deferred credit in the balance sheet at the end of 1983 and 1984.

N85#60. The property, plant, and equipment of a not-for-profit hospital should be accounted for as part of

- Unrestricted funds.
- Restricted funds.
- Specific purpose funds.
- Other nonoperating funds.

M85#59. Which of the following should be included in the current funds revenues of a not-for-profit private university?

	<u>Tuition waivers</u>	<u>Unrestricted bequests</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M85#60. Revenue from the gift shop of a hospital would normally be included in

- Other nonoperating revenue.
- Other operating revenue.
- Patient service revenue.
- Professional services revenue.

SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards

B. Conceptual Framework	N85# 2 d M85# 1 d	F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts
M89# 1 a	C. Basic Concepts and Accounting Principles	
N88# 1 b	M85# 2 a	M88# 4 d
M88# 1 b	E. Consolidated Financial Statements	M87# 2 a
M88# 2 b		N86# 4 a
M87# 1 a	M88# 3 b	M86# 2 a
N86# 1 b	N86# 3 c	N85# 4 a
N86# 2 b		M85# 3 a
M86# 1 d		
N85# 1 d		

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

A. Cash, Marketable Securities, and Investments	B. Receivables and Accruals	M86# 9 a M86#10 c M86#11 b M85# 6 d M85# 7 a M85# 8 d	M86#19 c M86#20 a M86#21 a N85# 5 c N85# 6 d M85# 9 b M85#10 a M85#11 d
N88# 2 b	M89# 2 b	D. Property, Plant, and Equipment Owned or Leased	
N88# 3 b	M89# 3 c	M89# 4 d	E. Intangibles and Other Assets
N88# 4 c	M88# 7 b	M89# 5 b	M89# 6 c
N88# 5 d	M87# 3 b	M88# 8 c	N88# 9 c
M88# 5 a	M87# 4 d	M88# 9 b	M88#10 d
M88# 6 c	M86# 7 c	N87# 4 b	N87# 9 b
M87# 5 a	M86# 8 d	N87# 5 b	M87# 9 b
M87# 6 b	N85# 3 b	N87# 6 b	N86# 11 d
M87# 7 d	C. Inventories	N87# 7 c	M86#12 b
M87# 8 a	N88# 6 a	N86# 8 d	N85# 7 d
N86#14 d	N88# 7 a	N86# 9 d	N85# 8 d
N86#15 b	N88# 8 b	N86#10 d	M85#12 d
M86# 4 d	N87# 1 a	M86#17 c	
M86# 5 c	N87# 2 c		
M86# 6 a	N87# 3 c		
M85# 4 c	N86# 5 c		
M85# 5 a	N86# 6 d		
	N86# 7 b		

Accounting Theory

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

A. Payables and Accruals N88# 10 b M88#11 a M87#10 b M87#11 a N86# 16 d M86#13 b M85#14 b M85#15 a	N87# 10 d M87#12 b N85# 9 b	E. Bonds Payable N88# 14 d N88# 15 b N88# 16 c M88#14 a M88#15 c M88#16 c M87#16 a M87#17 d M87#18 d N86# 17 d N86# 18 c	N86# 19 d N85# 12 d N85# 13 a N85# 15 b
B. Deferred Revenues N88# 11 d M88#12 b	D. Capitalized Lease Liability N88# 13 b N87# 11 c M87#13 c M87#14 b M86#26 c M86#27 d N85# 11 c		F. Contingent Liabilities and Commitments M89# 7 b M88#17 d M87#19 c M86#28 a N85# 19 d M85#16 c

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

A. Preferred and Common Stock M89# 8 b N88# 17 d N86# 20 a M85#19 c	N87# 14 c N87# 15 b M87#20 c M87#21 d N86# 21 c N86# 22 d M86#14 b M86#15 a M85#17 b	M88#20 d N87# 12 b M87#33 d N86# 23 c M86#31 b M85#18 a	N87# 19 a M87#34 b N86# 26 a M85#13 a
B. Additional Paid-in Capital M88#18 c M86#29 c	D. Treasury Stock and Other Contra Accounts M89#10 c N88# 19 c	E. Stock Options, Warrants, and Rights M89#11 c N88# 20 c M88#21 a	G. Partnerships M89#12 d N88# 21 d M88#22 c N87# 13 b M87#35 d M86#32 d
C. Retained Earnings and Dividends N88# 18 b M88#19 c			

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

A. Revenues and Gains M89#13 a M89#14 a M89#15 b M89#16 b N88# 22 c N88# 23 d N88# 24 c N88# 25 a M88#23 d M88#24 b	N87# 16 d N87# 17 b N87# 18 d M87#26 a M87#27 a N86# 24 d M86#33 c N85# 20 b N85# 21 a M85#21 c M85#32 c	B. Expenses and Losses M89#17 b M89#18 d M89#19 c M89#20 a M89#21 b N88# 26 c N88# 27 b N88# 28 d N88# 29 b M88#25 b	M88#26 c N87# 20 a N87# 21 d M87#22 c M87#23 d M87#24 d M87#25 b N86# 27 a M86#34 a N85# 16 b N85# 17 d M85#23 c
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Unofficial Answers

C. Provision for Income Tax	M89#22 a	M88#28 a	F. Earnings Per Share	M89#25 c N88#33 c M88#29 a N87#33 a M87#32 b N86#32 c M86#16 a N85#25 c M85#25 d
		N87#24 b		
		N86#31 b		
		M85#24 a		
D. Recurring Versus Nonrecurring Transactions and Events	M89#23 b N88#31 a	E. Accounting Changes M89#24 a N88#32 d N87#23 c N85#23 a		

VI. Other Financial Topics

A. Statement of Cash Flows	M89#26 c M89#27 a	N86#33 c M86#35 d	H. Segments and Lines of Business	M89#34 c M88#37 b N87#32 c N86#37 d N85#33 b M85#31 d	N87#38 d M87#40 b N86#39 a M86#39 a
B. Accounting Policies	M89#28 c M88#32 b N87#25 a M86#36 c N85#30 c	E. Business Combinations M89#30 b M89#31 c M88#34 d M88#35 b N87#29 a N86#34 b N85#32 c M85#29 c	I. Employee Benefits	M89#35 a M89#36 a N88#38 c N87#36 a N87#37 d M87#39 c M85#34 d	K. Development Stage Enterprises M89#38 c M88#39 c N85#34 c
C. Accounting Changes	M89#29 c N87#26 a N86#36 c M85#28 c	F. Interim Financial Statements M89#32 b N88#37 b M88#36 c N87#30 c N86#35 c M86#37 c M85#30 b	J. Analysis of Financial Statements	M89#37 d N88#39 a M88#38 c	L. Personal Financial Statements M89#39 a N88#40 c M88#40 a N87#39 c N86#40 b M85#33 b
D. Nonmonetary Transactions	N88#36 d M88#33 b N87#27 b	G. Gain Contingencies M89#33 c N87#31 c	M. Combined Financial Statements	M89#40 c N87#40 c	

VII. Cost Accumulation, Planning, and Control

A. Nature of Cost Elements	M89#41 b N88#41 c M88#41 d N87#45 c M87#41 a N86#41 a M86#41 d N85#36 d N85#37 a	M85#36 a M85#37 d	B. Process and Job Order Costing M89#42 b N88#42 b M88#42 a N87#41 d M87#42 d N86#42 a	M86#42 c N85#38 c N85#39 d M85#38 c M85#41 a	N86#43 d M86#43 c N85#40 d N85#41 b M85#39 a M85#40 a
C. Standard Costing	N88#43 d M88#43 b N87#42 d M87#43 c				

Accounting Theory

D. Joint and By-Product Costing, Spoilage, Waste, and Scrap			M86#47 a	M88#49 c
			M85#44 a	N87# 44 c
				M87#49 b
				N86# 47 c
				M86#49 c
				M85#47 c
E. Absorption and Variable Costing				
F. Budgeting and Flexible Budgeting				
G. Breakeven and Cost-Volume-Profit Analysis				
H. Capital Budgeting Techniques				
I. Performance Analysis				
J. Other				

VIII. Not-for-Profit and Governmental Accounting

A. Conceptual Framework				
B. Fund Accounting				
C. Types of Funds and Account Groups				
D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations				
E. Various Types of Not-for-Profit and Governmental Organizations				

ESSAYS — SELECTED QUESTIONS

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

M89

Number 2 (Estimated time — 15 to 25 minutes)

Vane Company has two portfolios of marketable equity securities. One is classified as a current asset, and the other is classified as a noncurrent asset. Vane does not have the ability to exercise significant influence over any of the companies in either portfolio. Some securities from each portfolio were sold during the year. One of the securities in the current portfolio was reclassified to the noncurrent portfolio when its market value was less than cost. At the beginning and end of the year, the aggregate cost of each portfolio exceeded its aggregate market value by different amounts.

Required:

- How should Vane measure and report the income statement effects of the securities sold during the year from each portfolio?
- How should Vane account for the security which was reclassified from the current asset portfolio to the noncurrent asset portfolio?
- How should Vane report the effects of investments in each portfolio in its balance sheet as of the end of the year and its income statement for the year? Why? **Do not discuss the securities sold.**

M89

Number 3 (Estimated time — 15 to 25 minutes)

Steel Company, a wholesaler that has been in business for two years, purchases its inventories from various suppliers. During the two years, each purchase has been at a lower price than the previous purchase.

Steel uses the lower of FIFO cost or market method to value inventories. The original cost of the inventories is above replacement cost and below the net realizable value. The net realizable value less the normal profit margin is below the replacement cost.

Required:

- In general, what criteria should be used to determine which costs should be included in inventory?
- In general, why is the lower of cost or market rule used to report inventory?
- At what amount should Steel's inventories be reported on the balance sheet? Explain the application of the lower of cost or market rule in this situation.

- What would have been the effect on ending inventories and net income for the second year had Steel used the lower of average cost or market inventory method instead of the lower of FIFO cost or market inventory method? Why?

N88

Number 2 (Estimated time — 15 to 25 minutes)

Hogan Company uses the net method of accounting for sales discounts. Hogan also offers trade discounts to various groups of buyers.

On August 1, 1987, Hogan factored some accounts receivable on a without recourse basis. Hogan incurred a finance charge.

Hogan also has some notes receivable bearing an appropriate rate of interest. The principal and total interest are due at maturity. The notes were received on October 1, 1987, and mature on September 30, 1989. Hogan's operating cycle is less than one year.

Required:

- Using the net method, how should Hogan account for the sales discounts at the date of sale? What is the rationale for the amount recorded as sales under the net method?
 - Using the net method, what is the effect on Hogan's sales revenues and net income when customers do not take the sales discounts?
- What is the effect of trade discounts on sales revenues and accounts receivable? Why?
- How should Hogan account for the accounts receivable factored on August 1, 1987? Why?
- How should Hogan report the effects of the interest-bearing notes receivable on its December 31, 1987, balance sheet and its income statement for the year ended December 31, 1987? Why?

N88

Number 3 (Estimated time — 15 to 25 minutes)

At the beginning of the year, Patrick Company acquired a computer to be used in its operations. The computer was delivered by the supplier, installed by Patrick, and placed into operation. The estimated useful life of the computer is five years, and its estimated residual (salvage) value is significant.

Accounting Theory

During the year, Patrick received cash in exchange for an automobile that was purchased in a prior year.

Required:

- a. 1. What costs should Patrick capitalize for the computer?
2. What is the objective of depreciation accounting? **Do not discuss specific methods of depreciation.**
- b. What is the rationale for using accelerated depreciation methods?
- c. How should Patrick account for and report the disposal of the automobile?

M88

Number 2 (Estimated time — 15 to 25 minutes)

Hudson Company, which is both a wholesaler and a retailer, purchases its inventories from various suppliers.

Additional facts for Hudson's wholesale operations are as follows:

- Hudson incurs substantial warehousing costs.
- Hudson uses the lower of cost or market method.
- The replacement cost of the inventories is below the net realizable value and above the net realizable value less the normal profit margin. The original cost of the inventories is above the replacement cost and below the net realizable value.

Additional facts for Hudson's retail operations are as follows:

- Hudson determines the estimated cost of its ending inventories held for sale at retail using the conventional retail inventory method, which approximates lower of average cost or market.
- Hudson incurs substantial freight-in costs.
- Hudson has net markups and net markdowns.

Required:

- a. Theoretically, how should Hudson account for the warehousing costs related to its wholesale inventories? Why?
- b. 1. In general, why is the lower of cost or market method used to report inventory?
2. At which amount should Hudson's wholesale inventories be reported on the balance sheet? Explain the application of the lower of cost or market method in this situation.
- c. In the calculation of the cost to retail percentage used to determine the estimated cost of its ending retail inventories, how should Hudson treat
 1. Freight-in costs?
 2. Net markups?
 3. Net markdowns?
- d. Why does Hudson's retail inventory method approximate lower of average cost or market?

N87

Number 2 (Estimated time — 15 to 25 minutes)

Tidal Company has significant amounts of trade accounts receivable. In March of this year, Tidal assigned specific trade accounts receivable to Herb Finance Company on a with recourse, nonnotification basis as collateral for a loan. Tidal signed a note and received 70 percent of the amount assigned. Tidal was charged a 5 percent finance fee and agreed to pay interest at 12 percent on the unpaid balance. Some specific accounts of the assigned receivables were written off as uncollectible. The remainder of the trade accounts receivable assigned were collected by Tidal in March and April of this year. Tidal paid Herb Finance in full at the end of April of this year.

Tidal also sold some special order merchandise and received a 90-day, 15 percent, interest-bearing note receivable on July 1 of this year. After 30 days, the note receivable was discounted with recourse at 18 percent at a bank.

Required:

- a. How should Tidal account for the transactions described above for the assignment of trade accounts receivable?
- b. 1. How should Tidal determine the amount of the discount for the note receivable?
2. How should the discounting transaction be accounted for?

N87

Number 3 (Estimated time — 15 to 25 minutes)

Houston Company has a portfolio of marketable equity securities that it classifies as a current asset. Houston owns less than five percent of the outstanding voting stock of each company's securities in the portfolio. At the beginning of the year, the aggregate market value of the portfolio exceeded its aggregate cost. Cash dividends on these securities were received during the year. All cash dividends received represent distributions of earnings subsequent to Houston's acquisition of these securities. Some of the securities in the portfolio were sold during the year. At the end of the year, the aggregate cost of the portfolio exceeded its aggregate market value.

Houston owns forty percent of the outstanding voting stock of Joy Company. The remainder of Joy's outstanding voting stock is widely dispersed among unrelated investors.

Required:

- a. 1. How should Houston report the income statement effects of the cash dividends received during the year on the securities in the portfolio that it classifies as a current asset?
2. How should Houston report the income statement effects of the securities sold during the year?

Selected Questions

b. How should Houston report the effect of ownership of the portfolio that it classifies as a current asset in its balance sheet as of the end of the year and income statement for the year? Why? Do **not** discuss the cash dividends or the securities sold.

c. Identify the method of accounting that Houston should use for its forty percent investment in the outstanding voting stock of Joy. Why is this method appropriate?

M87

Number 2 (Estimated time — 15 to 25 minutes)

Deskin Company purchased a new machine to be used in its operations. The new machine was delivered by the supplier, installed by Deskin, and placed into operation. It was purchased under a long-term payment plan for which the interest charges approximated the prevailing market rates. The estimated useful life of the new machine is ten years, and its estimated residual (salvage) value is significant. Normal maintenance was performed to keep the new machine in usable condition.

Deskin also added a wing to the manufacturing building that it owns. The addition is an integral part of the building. Furthermore, Deskin made significant leasehold improvements to office space used as corporate headquarters.

Required:

a. What costs should Deskin capitalize for the new machine? How should the machine be depreciated? **Do not discuss specific methods of depreciation.**

b. How should Deskin account for the normal maintenance performed on the new machine? Why?

c. How should Deskin account for the wing added to the manufacturing building? Where should the added wing be reported on Deskin's financial statements?

d. How should Deskin account for the leasehold improvements made to its office space? Where should the leasehold improvements be reported on Deskin's financial statements?

M87

Number 3 (Estimated time — 15 to 25 minutes)

Hanlon Company purchased a significant amount of raw materials inventory for a new product that it is manufacturing. Hanlon purchased insurance on these raw materials while they were in transit from the supplier.

Hanlon uses the lower of cost or market rule for these raw materials. The replacement cost of the raw materials is above the net realizable value and both are below the original cost.

Hanlon uses the average cost inventory method for these raw materials. In the last two years, each purchase has been at a lower price than the previous purchase, and the ending inventory quantity for each period has been higher than the beginning inventory quantity for that period.

Required:

a. What is the theoretically appropriate method that Hanlon should use to account for the insurance costs on the raw materials while they were in transit from the supplier? Why?

b. 1. At which amount should Hanlon's raw materials inventory be reported on the balance sheet? Why?

2. In general, why is the lower of cost or market rule used to report inventory?

c. What would have been the effect on ending inventory and cost of goods sold had Hanlon used the LIFO inventory method instead of the average cost inventory method for the raw materials? Why?

N86

Number 2 (Estimated time — 15 to 25 minutes)

Anth Company has significant amounts of trade accounts receivable. Anth uses the allowance method to estimate bad debts instead of the specific write-off method. During the year, some specific accounts were written off as uncollectible, and some that were previously written off as uncollectible were collected.

Anth also has some interest-bearing notes receivable for which the face amount plus interest at the prevailing rate of interest is due at maturity. The notes were received on July 1, 1985, and are due on June 30, 1987.

Required:

a. What are the deficiencies of the specific write-off method?

b. What are the two basic allowance methods used to estimate bad debts, and what is the theoretical justification for each?

c. How should Anth account for the collection of the specific accounts previously written off as uncollectible?

d. How should Anth report the effects of the interest-bearing notes receivable on its December 31, 1986, balance sheet and its income statement for the year ended December 31, 1986? Why?

N85

Number 2 (Estimated time — 15 to 25 minutes)

Gehl Company purchased significant amounts of new equipment this year to be used in its operations. The equipment was delivered by the suppliers, installed by Gehl, and placed into operation. Some of it was purchased for cash with discounts available for prompt payment. Some of it was purchased under long-term payment plans for which the interest charges approximate prevailing rates. As a result, Gehl is studying its capitalization and depreciation policies.

Required:

a. What costs should Gehl capitalize for the new equipment purchased this year?

Accounting Theory

- b. What factors cause the equipment to lose its future economic benefit?
- c. What factors should be considered in computing the equipment's depreciation expense?
- d. What theoretical justifications are there for the use of accelerated depreciation methods?

N85

Number 3 (Estimated time — 15 to 25 minutes)

Caddell Company, a wholesaler, purchases its inventories from various suppliers FOB destination; it incurs substantial warehousing costs. Caddell uses the dollar value LIFO inventory cost flow method. Caddell also consigns some of its inventories to Reed Company.

Reed also has items for sale that it purchases from other wholesalers. Reed uses the lower of FIFO cost or market inventory method.

Required:

- a. When should the purchases from various suppliers generally be included in Caddell's inventory? Why?
- b. Theoretically, how should Caddell account for the warehousing costs? Why?
- c. 1. What are the advantages of using the dollar value LIFO inventory cost flow method as opposed to the conventional quantity of goods LIFO method?
2. How does the calculation of dollar value LIFO differ from the conventional quantity of goods method?
- d. How should Caddell account for the inventories consigned to Reed Company? Why?
- e. When Reed applies the lower of cost or market method, what are the ceiling and floor limits?

N85

Number 4 (Estimated time — 15 to 25 minutes)

Walker Company has a noncurrent marketable equity securities portfolio. Walker does not own more than five percent of the outstanding voting stock for any of the securities in the portfolio. At the beginning of the year, the aggregate market value of the portfolio exceeded its cost. Cash dividends on these securities were received during the year. None of the securities in the portfolio were sold during the year. At the end of the year, the aggregate cost of the portfolio exceeded its market value. The decline in the market price of the securities in the portfolio is attributable to general market decline.

During the year, Walker purchased for cash thirty-five percent of the outstanding voting stock of Sipe Company. Cash dividends on this investment were re-

ceived from Sipe during the year, and the earnings of Sipe after the acquisition date were reported by Sipe to Walker.

Required:

- a. How should Walker report on its balance sheet and income statement the effects of its investment in the noncurrent marketable equity securities portfolio for the year? Why?
- b. How should Walker report on its balance sheet and income statement the effects of its investment in Sipe for the year? Why?

M85

Number 3 (Estimated time — 15 to 25 minutes)

On July 1, 1984, Marie Company sold special-order merchandise on credit and received in return an interest-bearing note receivable from the customer. Marie will receive interest at the prevailing rate for a note of this type. Both the principal and interest are due in one lump sum on June 30, 1985.

On September 1, 1984, Marie sold special-order merchandise on credit and received in return a non-interest-bearing note receivable from the customer. The prevailing rate of interest for a note of this type is determinable. The note receivable is due in one lump sum on August 31, 1986.

Marie also has significant amounts of trade accounts receivable as a result of credit sales to its customers. On October 1, 1984, some trade accounts receivable were assigned to Daniel Finance Company on a with recourse, nonnotification basis for an advance of 75% of their amount at an interest charge of 20% on the balance outstanding.

On November 1, 1984, other trade accounts receivable were factored on a without recourse basis. The factor withheld 5% of the trade accounts receivable factored as protection against sales returns and allowances and charged a finance charge of 3%.

Required:

- a. How should Marie determine the interest income for 1984 on the
 - 1. interest-bearing note receivable? Why?
 - 2. noninterest-bearing note receivable? Why?
- b. How should Marie report the interest-bearing note receivable and the noninterest-bearing note receivable on its balance sheet at December 31, 1984?
- c. How should Marie account for subsequent collections on the trade accounts receivable assigned on October 1, 1984, and the payments to Daniel Finance? Why?
- d. How should Marie account for the trade accounts receivable factored on November 1, 1984? Why?

Selected Questions

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

M89

Number 4 (Estimated time — 15 to 25 minutes)

On January 2, 1988, Druid Company issued 9% term bonds dated January 2, 1988, at an effective interest rate (yield) of 10%. Druid uses the effective interest method of amortization.

On December 1, 1988, Druid issued 8% nonconvertible bonds dated December 1, 1988, with detachable stock purchase warrants. Immediately after issuance, both the bonds and the warrants have separately determined fair market values.

Required:

- a. How would the issue price of the 9% bonds be determined?
- b. 1. Were the 9% bonds issued at par, at a discount, or at a premium? Why?
2. Using the effective interest method of amortization, would the amount of interest expense for the 9% bonds be higher in the first year or second year? Why?
- c. How should Druid account for the proceeds from the issuance of the 8% nonconvertible bonds with detachable stock purchase warrants? Why?

M89

Number 5 (Estimated time — 15 to 25 minutes)

On January 1, 1988, Von Company entered into two noncancellable leases for new machines to be used in its manufacturing operations. The first lease does not contain a bargain purchase option; the lease term is equal to 80 percent of the estimated economic life of the machine. The second lease contains a bargain purchase option; the lease term is equal to 50 percent of the estimated economic life of the machine.

Required:

- a. What is the theoretical basis for requiring lessees to capitalize certain long-term leases? **Do not discuss the specific criteria for classifying a lease as a capital lease.**
- b. How should a lessee account for a capital lease at its inception?
- c. How should a lessee record each minimum lease payment for a capital lease?
- d. How should Von classify each of the two leases? Why?

N88

Number 4 (Estimated time — 15 to 25 minutes)

Skinner Company has the following contingencies:

- Potential costs due to the discovery of a possible defect related to one of its products. These costs are probable and can be reasonably estimated.

- A potential claim for damages to be received from a lawsuit filed this year against another company. It is probable that proceeds from the claim will be received by Skinner next year.
- Potential costs due to a promotion campaign whereby a cash refund is sent to customers when coupons are redeemed. Skinner estimated, based on past experience, that 70 percent of the coupons would be redeemed. Forty percent of the coupons were actually redeemed and the cash refunds sent this year. The remaining 30 percent of the coupons are expected to be redeemed next year.

Required:

- a. How should Skinner report the potential costs due to the discovery of a possible product defect? Why?
- b. How should Skinner report this year the potential claim for damages that may be received next year? Why?
- c. This year, how should Skinner account for the potential costs and obligations due to the promotion campaign?

M88

Number 4 (Estimated time — 15 to 25 minutes)

On January 1, 1987, Metcalf Company sold equipment for cash and leased it back. As seller-lessee, Metcalf retained the right to substantially all of the remaining use of the equipment.

The term of the lease is eight years. There is a gain on the sale portion of the transaction. The lease portion of the transaction is classified appropriately as a capital lease.

Required:

- a. What is the theoretical basis for requiring lessees to capitalize certain long-term leases? **Do not discuss the specific criteria for classifying a lease as a capital lease.**
- b. 1. How should Metcalf account for the sale portion of the sale-leaseback transaction at January 1, 1987?
2. How should Metcalf account for the lease-back portion of the sale-leaseback transaction at January 1, 1987?
- c. How should Metcalf account for the gain on the sale portion of the sale-leaseback transaction during the first year of the lease? Why?

N87

Number 4 (Estimated time — 15 to 25 minutes)

Spackenkill Company is a manufacturer of household appliances. During the year, the following information became available:

- Potential costs due to the discovery of a safety hazard related to one of its products — These costs are probable and can be reasonably estimated.

- Potential costs of new product warranty costs — These costs are probable but cannot be reasonably estimated.
- Potential costs due to the discovery of a possible product defect related to one of its products — These costs are reasonably possible and can be reasonably estimated.

Required:

- a. How should Spackenkill report the potential costs due to the discovery of a safety hazard? Why?
- b. How should Spackenkill report the potential costs of warranty costs? Why?
- c. How should Spackenkill report the potential costs due to the discovery of a possible product defect? Why?

N87

Number 5 (Estimated time — — 15 to 25 minutes)

On January 1, 1985, Brewster Company issued 2,000 of its five-year, \$1,000 face value, 11% bonds dated January 1 at an effective annual interest rate (yield) of 9%. Brewster uses the effective interest method of amortization. On December 31, 1986, the 2,000 bonds were extinguished early through acquisition in the open market by Brewster for \$1,980,000.

On July 1, 1985, Brewster issued 5,000 of its six-year, \$1,000 face value, 10% convertible bonds dated July 1 at an effective annual interest rate (yield) of 12%. The convertible bonds are convertible at the option of the investor into Brewster's common stock at a ratio of 10 shares of common stock for each bond. Brewster uses the effective interest method of amortization. On July 1, 1986, an investor in Brewster's convertible bonds tendered 1,500 bonds for conversion into 15,000 shares of Brewster's common stock which had a market value of \$105 per share at the date of the conversion.

Required:

- a. 1. Were the 11% bonds issued at par, at a discount, or at a premium? Why?
2. Would the amount of interest expense for the 11% bonds using the effective interest method of amortization be higher in the first or second year of the life of the bond issue? Why?
- b. 1. How should gain or loss on early extinguishment of debt be determined? Does the early extinguishment of the 11% bonds result in a gain or loss? Why?
2. How should Brewster report the early extinguishment of the 11% bonds on the 1986 income statement?
- c. 1. Would recording the conversion of the 10% convertible bonds into common stock under the book value method affect net income? What is the rationale for the book value method?
2. Would recording the conversion of the 10% convertible bonds into common stock under the market value method affect net income? What is the rationale for the market value method?

N86

Number 3 (Estimated time — — 15 to 25 minutes)

On January 1, 1985, Hendrick Company entered into two noncancellable leases for machines to be used in its manufacturing operations. The first lease transfers ownership of the machine to the lessee by the end of the lease term. The second lease contains a bargain purchase option. Payments have been made on both leases during 1985.

Required:

- a. How should Hendrick classify each of the two leases? Why?
- b. How should a lessee report a capital lease on its balance sheet and income statement?
- c. How should a lessee report an operating lease on its balance sheet and income statement?

N86

Number 4 (Estimated time — — 15 to 25 minutes)

Cope Company is a manufacturer of household appliances. During the year, the following information became available:

- Probable warranty costs on its household appliances are estimated to be 1% of sales.
- One of its manufacturing plants is located in a foreign country. There is a threat of expropriation of this plant. The threat of expropriation is deemed to be reasonably possible. Any compensation from the foreign government would be less than the carrying amount of the plant.
- It is probable that damages will be received by Cope next year as a result of a lawsuit filed this year against another household appliances manufacturer.

Required: In answering the following, do not discuss deferred income tax implications.

- a. How should Cope report the probable warranty costs? Why?
- b. How should Cope report the threat of expropriation of assets? Why?
- c. How should Cope report this year the probable damages that may be received next year? Why?

M86

Number 5 (Estimated time — — 15 to 25 minutes)

On November 1, 1985, Abbott Company sold its 5-year, \$1,000 face value, 11% term bonds dated October 1, 1985, at a discount resulting in an effective annual interest rate (yield) of 12%. Interest is payable semiannually, and the first interest payment date is April 1, 1986. Abbott uses an acceptable method of amortizing bond discount. Bond issue costs were incurred in preparing and selling the bond issue.

Selected Questions

On December 1, 1985, Abbott sold its 6-year, \$1,000 face value, 9% nonconvertible bonds with detachable stock warrants for an amount exceeding the sum of the face value of the bonds and the fair value of the warrants.

Required:

- a. What facts above determined that the 11% term bonds were sold at a discount? Why?
- b. How would all the items related to the 11% term bonds, except cash, be presented in a balance sheet prepared immediately after the term bond issue was sold, and in a balance sheet prepared at December 31, 1985?
 - c. 1. Over what period of time would the bond discount be amortized?
 2. Compare the straight-line and the interest methods of amortization.
 3. Which of the two methods is preferable? Why?
- d. How should Abbott account for the proceeds from the sale of the 9% nonconvertible bonds with detachable stock purchase warrants? Why?

M85

Number 2 (Estimated time — 15 to 25 minutes)

On January 1, 1984, Lani Company entered into a noncancelable lease for a machine to be used in its manufacturing operations. The lease transfers ownership of the machine to Lani by the end of the lease term. The term of the lease is eight years. The minimum lease payment made by Lani on January 1, 1984, was one of eight equal annual payments. At the inception of the lease, the criteria established for classification as a capital lease by the lessee were met.

Required:

- a. What is the theoretical basis for the accounting standard which requires certain long-term leases to be capitalized by the lessee? Do not discuss the specific criteria for classifying a specific lease as a capital lease.
- b. How should Lani account for this lease at its inception and determine the amount to be recorded?

c. What expenses related to this lease will Lani incur during the first year of the lease, and how will they be determined?

d. How should Lani report the lease transaction on its December 31, 1984, balance sheet?

M85

Number 4 (Estimated time — 15 to 25 minutes)

On October 1, 1984, Janine Company sold some of its 5-year, \$1,000 face value, 12% term bonds dated March 1, 1984 at an effective annual interest rate (yield) of 10%. Interest is payable semiannually and the first interest payment date is September 1, 1984. Janine uses the interest method of amortization. Bond issue costs were incurred in preparing and selling the bond issue.

On November 1, 1984, Janine sold directly to underwriters at a lump-sum price, \$1,000 face value, 9% serial bonds dated November 1, 1984 at an effective annual interest rate (yield) of 11%. A total of 25% of these serial bonds are due on November 1, 1986, a total of 35% on November 1, 1987, and a total of 40% on November 1, 1988. Interest is payable semiannually and the first interest payment date is May 1, 1985. Janine uses the interest method of amortization. Bond issue costs were incurred in preparing and selling the bond issue.

Required:

- a. How would the market price of the term bonds and the serial bonds be determined?
- b. 1. How would all items related to the term bonds, except for bond issue costs, be presented in a balance sheet prepared immediately after the term bond issue was sold?
2. How would all items related to the serial bonds, except for bond issue costs, be presented in a balance sheet prepared immediately after the serial bond issue was sold?
- c. What alternative methods could be used to account for the bond issue costs for the term bonds in 1984?
- d. How would the amount of interest expense for the term bonds and the serial bonds be determined for 1984?

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

N85

Number 5 (Estimated time — 15 to 25 minutes)

Brady Company has 30,000 shares of \$10 par value common stock authorized and 20,000 shares issued and outstanding. On August 15, 1984, Brady purchased 1,000 shares of treasury stock for \$12 per share. Brady uses the cost method to account for treasury stock. On September 14, 1984, Brady sold 500 shares of the treasury stock for \$14 per share.

In October 1984, Brady declared and distributed 2,000 shares as a stock dividend from unissued shares when the market value of the common stock was \$16 per share.

On December 20, 1984, Brady declared a \$1 per share cash dividend, payable on January 10, 1985, to shareholders of record on December 31, 1984.

Required:

a. How should Brady account for the purchase and sale of the treasury stock, and how should the treasury stock be presented in Brady's balance sheet at December 31, 1984?

b. How should Brady account for the stock dividend, and how would it affect Brady's stockholders' equity at December 31, 1984? Why?

c. How should Brady account for the cash dividend, and how would it affect Brady's balance sheet at December 31, 1984? Why?

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

M88

Number 3 (Estimated time — 15 to 25 minutes)

There are various types of accounting changes, each of which is required to be reported differently.

Required:

a. What type of accounting change is a change from the sum-of-the-years'-digits method of depreciation to the straight-line method for previously recorded assets? Under what circumstances does this type of accounting change occur?

b. What type of accounting change is a change in the expected service life of an asset arising because of more experience with the asset? Under what circumstances does this type of accounting change occur?

c. With respect to a change in accounting principle,

1. How should a company calculate the effect?

2. How should a company report the effect?

Do not discuss earnings per share requirements.

d. 1. Why are accounting principles, once adopted, normally continued?

2. What is the rationale for disclosure of a change from one accounting principle to another accounting principle?

be included in the net pension cost recognized for a period are service cost, interest cost, and actual return on plan assets.

Required:

a. What two accounting problems result from the nature of the defined benefit pension plan? Why do these problems arise?

b. How should Carson determine the service cost component of the net pension cost?

c. How should Carson determine the interest cost component of the net pension cost?

d. How should Carson determine the actual return on plan assets component of the net pension cost?

M87

Number 4 (Estimated time — 15 to 25 minutes)

Lynn Company discontinued operations of a segment of its business in the middle of the year. The segment was operating at a loss from the beginning of the year. At the measurement date, a loss is expected from the proposed sale of the segment. This expected loss includes operating losses during the phase-out period which will extend into next year.

In addition, Lynn had one of its manufacturing plants destroyed by an earthquake during the year. The loss is properly reported as an extraordinary item.

Required:

a. How should Lynn report discontinued operations of a segment of its business on its income statement for this year? **Do not discuss earnings per share requirements.**

M88

Number 5 (Estimated time — 15 to 25 minutes)

Carson Company sponsors a single-employer defined benefit pension plan. The plan provides that pension benefits are determined by age, years of service, and compensation. Among the components that should

Selected Questions

- b. What are the criteria for classification as an extraordinary item?
- c. How should Lynn report the extraordinary loss from the earthquake on its income statement for this year? **Do not discuss earnings per share requirements.**

N86

Number 5 (Estimated time — — 15 to 25 minutes)

Wesley Company granted compensatory common stock options to its executives on January 1, 1983, the measurement date, for services to be rendered during 1983 and 1984. The quoted market price of Wesley's par value common stock exceeded the option price on January 1, 1983.

The stock options were exercisable beginning on January 1, 1985, and they lapsed on December 31, 1985. Half of the stock options were exercised in 1985 and half were allowed to lapse.

Required:

- a. How should Wesley determine the amount of compensation expense related to the compensatory stock options, if any, that should be recognized in its income statements for 1983, 1984, and 1985? Why?
- b. How should Wesley account for the exercise of the stock options? Justify the accounting recommended.
- c. How should Wesley account for the lapse of the stock options? Justify the accounting recommended.

M86

Number 2 (Estimated time — — 15 to 25 minutes)

Village Company is accounting for a long-term construction contract using the percentage-of-completion method. It is a three-year fixed-fee contract that is presently in its first year. The latest reasonable estimates of total contract costs indicate that the contract will be completed at a profit. Village will submit progress billings to the customer and has reasonable assurance that collections on these billings will be received in each year of the contract.

Required:

- a. 1. What is the justification for the percentage-of-completion method for long-term construction contracts?
- 2. What facts in the situation above indicate that Village should account for this long-term construction contract using the percentage-of-completion method?
- b. How would the income recognized in each year of this long-term construction contract be determined using the cost-to-cost method of determining percentage of completion?
- c. What is the effect on income, if any, of the progress billings and the collections on these billings?

M86

Number 3 (Estimated time — — 15 to 25 minutes)

Berkeley Company, a manufacturer of many different products, changed its depreciation method for its production machinery from the double-declining balance method to the straight-line method effective January 1, 1985. The straight-line method was determined to be preferable.

In addition, Berkeley changed the salvage values used in computing depreciation for its office equipment. This change was made on January 1, 1985, because additional information was obtained.

On December 31, 1985, Berkeley changed the specific subsidiaries comprising the group of companies for which consolidated financial statements are presented.

Required:

- a. What kind of accounting change is each of the three situations described above? For each situation indicate whether or not each should show:
 - The cumulative effect of a change in accounting principle in net income of the period of change.
 - Pro forma effects of retroactive application.
 - Restatement of the financial statements of all prior periods.
- b. Why does a change in accounting principle have to be disclosed by the company?

VI. Other Financial Topics

N88

Number 5 (Estimated time — 15 to 25 minutes)

There are two methods of accounting for business combinations, purchase and pooling of interests.

Required:

a. 1. What is the rationale for accounting for a business combination as a purchase? **Do not discuss the specific criteria for accounting for a business combination as a purchase.**

2. In a business combination accounted for as a purchase, how should the amount of goodwill at acquisition be determined?

3. In a business combination accounted for as a purchase, how should goodwill be amortized?

b. 1. What is the rationale for accounting for a business combination as a pooling of interests? **Do not discuss the specific criteria for accounting for a business combination as a pooling of interests.**

2. In a business combination accounted for as a pooling of interests, when both companies use the same methods of accounting, how should the stockholders' equity be accounted for?

M87

Number 5 (Estimated time — 15 to 25 minutes)

Flaherty Company entered into a business combination with Steeley Company in the middle of the year. The combination was accounted for as a pooling of interests. Both companies use the same methods of accounting. Registration fees for the equity securities involved in the combination were incurred. There were no intercompany transactions before or after the combination.

Flaherty Company acquired all of the voting common stock of Rubin Company in the middle of the year. This combination was accounted for as a purchase and resulted in goodwill. Both companies use the same methods of accounting. Registration fees for the equity securities involved in the combination were incurred. There were no intercompany transactions before or after the combination.

Required:

a. 1. In the business combination accounted for as a pooling of interests, how should the recorded assets and liabilities of the separate companies be accounted for? What is the rationale for accounting for a business combination as a pooling of interests?

2. In the business combination accounted for as a pooling of interests, how should the registration fees and direct costs related to effecting the business combination be accounted for?

3. In the business combination accounted for as a pooling of interests, how should the results of operations for the year in which the business combination occurred be reported?

b. 1. In the business combination accounted for as a purchase, how should the assets acquired and liabilities assumed be recorded? What is the rationale for accounting for a business combination as a purchase?

2. In the business combination accounted for as a purchase, how should the registration fees and direct costs related to effecting the business combination be accounted for?

3. In the business combination accounted for as a purchase, how should the results of operations of the acquired company for the year in which the business combination occurred be reported?

M86

Number 4 (Estimated time — 15 to 25 minutes)

Spellman Company will acquire 90% of Moore Company in a business combination. The total consideration has been agreed upon. The nature of Spellman's payment has not been fully agreed upon. Therefore, it is possible that this business combination might be accounted for as either a purchase or a pooling of interests. It is expected that at the date the business combination is to be consummated, the fair value will exceed the book value of Moore's assets minus liabilities. Spellman desires to prepare consolidated financial statements which will include the financial statements of Moore.

Required:

a. 1. Would the method of accounting for the business combination (purchase vs. pooling of interests) affect whether or not goodwill is reported?

2. If goodwill is reported, explain how the amount of goodwill is determined.

3. Would the method of accounting for the business combination (purchase vs. pooling of interests) affect whether or not minority interest is reported? If the amount reported differs, explain why.

b. 1. From a theoretical standpoint, why should consolidated financial statements be prepared?

2. From a theoretical standpoint, what is the usual first necessary condition to be met before consolidated financial statements can be prepared?

3. From a theoretical standpoint, does the method of accounting for the business combination (purchase vs. pooling of interests) affect the decision to prepare consolidated financial statements? Why?

SELECTED ESSAYS — UNOFFICIAL ANSWERS

II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles

M89

Answer 2 (10 points)

a. The differences between the selling prices and the costs of securities sold should be reported as realized gains and losses in the determination of net income.

b. The security in the current portfolio should be reclassified to the noncurrent portfolio at the lower of its cost or market value at the date of reclassification. Since its market value was less than cost, the market value becomes the new cost basis. The excess of cost over market value at the date of reclassification should be reported as a realized loss in the determination of net income.

c. Each portfolio should be reported in the balance sheet at its separately determined lower of aggregate cost or market value. Applying this rule, Vane would report each portfolio at market by using a valuation allowance (contra) account for the excess of aggregate cost over aggregate market value.

For the current portfolio, the change in the valuation allowance (contra) account that occurred during the year should be reported as an unrealized gain or loss in the income statement. For the noncurrent portfolio, an amount equal to the valuation allowance (contra) account balance should be reported separately in the equity section of the balance sheet.

Reporting the portfolio at market value reflects the realizable value of the portfolio at the end of the period and is consistent with conservatism. For the current portfolio, the estimated loss is reported (matched) in the income statement in the period in which the change in realizable value occurred. Reporting the current portfolio at market indicates the expected cash flow from the sale of the securities. Inclusion of the reduction in market value of the current portfolio in net income assists in cash flow projections by acknowledging the expected impairment in future cash flows as a consequence of the investment. For the noncurrent portfolio, the decline in market value (loss) is less certain of realization in the near term, and may not be a reasonable estimate of the cash flow consequence of the investment. Therefore, changes in market value of the noncurrent portfolio are not considered useful for cash flow projections.

M89

Answer 3 (10 points)

a. Inventory cost should include all reasonable and necessary costs of preparing inventory for sale. These costs include not only the purchase price of the inventories, but also other costs associated with readying inventories for sale.

b. The lower of cost or market rule produces a realistic estimate of future cash flows to be realized from the sale of inventories. This is consistent with the principle of conservatism, and recognizes (matches) the anticipated loss in the income statement in the period in which the price decline occurs.

c. Steel's inventories should be reported on the balance sheet at market. According to the lower of cost or market rule, market is defined as replacement cost. Market cannot exceed net realizable value and cannot be less than net realizable value less the normal profit margin. In this instance, replacement cost is between net realizable value and net realizable value less the normal profit margin. Therefore, market is established as replacement cost. Since market is less than original cost, inventory should be reported at market.

d. Ending inventories and net income would have been the same under either lower of average cost or market or lower of FIFO cost or market. In periods of declining prices, the lower of cost or market rule results in a write-down of inventory cost to market under both methods, resulting in the same inventory cost. Therefore, net income using either inventory method is the same.

N88

Answer 2 (10 points)

a. 1. Hogan should account for the sales discounts at the date of sale using the net method by recording accounts receivable and sales revenue at the amount of sales less the sales discounts available.

Revenues should be recorded at the cash equivalent price at the date of sale. Under the net method, the sale is recorded at an amount that represents the cash equivalent price at the date of exchange (sale).

2. There is no effect on Hogan's sales revenues when customers do not take the sales discounts. Hogan's net income is increased by the amount of interest (discount) earned when customers do not take the sales discounts.

b. Trade discounts are neither recorded in the accounts nor reported in the financial statements. Therefore, the amount recorded as sales revenues and accounts receivable is net of trade discounts and represents the cash equivalent price of the asset sold.

c. To account for the accounts receivable factored on August 1, 1987, Hogan should decrease accounts receivable by the amount of accounts receivable factored, increase cash by the amount received from the factor, and record a loss. Factoring of accounts receivable on a without recourse basis is equivalent to a sale. The difference between the cash received and the carrying amount of the receivables is a loss.

d. Hogan should report the face amount of the interest-bearing notes receivable and the related interest receivable for the period from October 1 through December 31 on its balance sheet as noncurrent assets. Both assets are due on September 30, 1989, which is more than one year from the date of the balance sheet.

Hogan should report interest revenue from the notes receivable on its income statement for the year ended December 31, 1987. Interest revenue is equal to the amount accrued on the notes receivable at the appropriate rate for three months.

Interest revenue is realized with the passage of time. Accordingly, interest revenue should be accounted for as an element of income over the life of the notes receivable.

N88

Answer 3 (10 points)

a. 1. The capitalized cost for the computer includes all costs reasonable and necessary to prepare it for its intended use. Examples of such costs are the cash purchase price, delivery, installation, testing, and set up.

2. The objective of depreciation accounting is to allocate the depreciable cost of an asset over its estimated useful life in a systematic and rational manner. This process matches the depreciable cost of the asset with revenues generated from its use. Depreciable cost is the capitalized cost less its estimated residual (salvage) value.

b. The rationale for using accelerated depreciation methods is based on the following assumptions:

- An asset is more productive in the earlier years of its estimated useful life. Therefore, larger depreciation charges in the earlier years would be matched against the larger revenues generated in the earlier years.

- An asset may become technologically obsolete prior to the end of its originally estimated useful life. The risk associated with estimated long-term cash flows is greater than the risk associated with near-term cash flows. Accelerated depreciation recognizes this condition.

c. Patrick should record depreciation expense to the date of disposal. Recording depreciation updates the carrying amount of the automobile. If the carrying amount of the automobile (capitalized cost less accumulated depreciation) differs from the cash proceeds from the disposal, a gain or loss results. Patrick should report gain or loss on disposal as part of income from continuing operations.

M88

Answer 2 (10 points)

a. Hudson should account for the warehousing costs related to its wholesale inventories as part of inventory. All reasonable and necessary costs of preparing inventory for sale should be recorded as inventory cost. This approach results in proper matching of the warehousing costs with revenue when the wholesale inventories are sold.

b. 1. The lower of cost or market method produces a more realistic estimate of future cash flows to be realized from assets, which is consistent with the principle of conservatism, and recognizes (matches) the anticipated loss in the income statement in the period in which the price decline occurs.

2. Hudson's wholesale inventories should be reported on the balance sheet at replacement cost. According to the lower of cost or market method, replacement cost is defined as market. However, market cannot exceed net realizable value and cannot be less than net realizable value less the normal profit margin. In this instance, replacement cost is below original cost, below net realizable value, and above net realizable value less the normal profit margin. Therefore, Hudson's wholesale inventories should be reported at replacement cost.

c. 1. Hudson's freight-in costs should be included only in the cost amounts to determine the cost to retail percentage.

2. Hudson's net markups should be included only in the retail amounts to determine the cost to retail percentage.

3. Hudson's net markdowns should not be deducted from the retail amounts to determine the cost to retail percentage.

d. By not deducting net markdowns from the retail amounts to determine the cost to retail percentage, Hudson produces a lower cost to retail percentage than would result if net markdowns were deducted. By applying this lower percentage to ending inventory at retail, the inventory is reported at an amount below cost, which approximates lower of average cost or market.

N87

Answer 2 (10 points)

a. Tidal should account for the assignment of trade accounts receivable by debiting trade accounts receivable assigned and crediting trade accounts receivable for the amount of trade accounts receivable assigned. Tidal should account for the note payable to Herb Finance by debiting cash for 70 percent, debiting finance fee expense for 5 percent, and crediting notes payable for 75 percent of the trade accounts receivable assigned.

Tidal should account for the subsequent collections on the trade accounts receivable assigned by debiting cash and crediting trade accounts receivable assigned. Tidal should account for the write off as uncollectible of some specific accounts of the assigned receivables by debiting allowance for doubtful accounts and crediting trade accounts receivable assigned.

Tidal should account for the total payment to Herb Finance by debiting interest expense and notes payable, and crediting cash. The amount of the cash payment consists of both principal (the amount of the note payable) and interest computed at a rate of 12 percent on the balance outstanding.

b. 1. Tidal should determine the amount of the discount for the note receivable as follows:

- Determine the maturity value of the note receivable (the face value of the note receivable plus the 15 percent interest to be earned over the 90-day life of the note receivable).
- Multiply the maturity value of the note receivable by one-sixth (the 60-day life of the discounted note receivable) of the 18 percent discount rate to arrive at the amount of the discount.

2. The discounting transaction should be accounted for by debiting cash and crediting notes receivable discounted. Cash would be debited for the amount received from the bank, and notes receivable discounted, a contra-asset account, generally would be credited for the face value of the note receivable. Also, interest expense should be debited for the difference between the amount received from the bank and the face value of the note receivable at the date of discounting plus interest income earned to the date of discounting and interest revenue should be credited for the interest income earned to the date of discounting. The income and expense, however, are usually netted against each other instead of being recorded separately when the amounts involved are immaterial.

N87

Answer 3 (10 points)

a. 1. Houston should report the cash dividends received during the year as dividend revenue in the income statement.

2. The realized gain or loss on the securities sold during the year should be reported as a part of net

income for the current year. The reported realized gains or losses should be measured as the difference(s) between the selling price and the cost of the securities sold.

b. Houston should report the portfolio as a current asset in its balance sheet. The portfolio should be presented at the lower of cost or market. Applying this rule, Houston should report the portfolio at market through the use of a valuation account. The amount by which the aggregate cost of the portfolio exceeded market value at the end of the year should be reported as an unrealized loss in its income statement.

Reporting the portfolio at market value reflects the realizable value of the portfolio at the end of the period. The estimated loss is reported (matched) in the income statement in the period in which the decline in realizable value occurred. Recognition of the lower market value and the anticipated loss is consistent with conservatism.

c. Houston should use the equity method of accounting for its forty percent investment in the outstanding voting stock of Joy. The equity method is appropriate when the company has the ability to exercise significant influence. Houston is presumed to be able to exercise significant influence over Joy because of the size of its investment and the wide dispersion of the remaining shares among unrelated investors.

M87

Answer 2 (10 points)

a. The capitalizable cost includes all costs relating to purchase or preparation for use. Such cost may include delivery and installation. The capitalizable cost represents the cash equivalent price and accordingly would not include interest charges.

The depreciable cost of the new machine should be allocated over its estimated useful life in a systematic and rational manner. Depreciable cost is the capitalizable cost less its estimated residual (salvage) value.

b. Normal maintenance performed on the new machine should not be capitalized as part of the machine's cost. It should be expensed as incurred if the machine is not used in the manufacturing process or should be inventoried as part of factory overhead if the machine is used in the manufacturing process. Normal maintenance does not enhance the service potential of the machine.

c. The wing added to the manufacturing building should be capitalized. The addition should be depreciated over its estimated useful life or the remaining useful life of the building of which it is an integral part, whichever is shorter. The addition should be included in the property, plant, and equipment section of the balance sheet.

Accounting Theory

d. The leasehold improvements made to the office space should be capitalized. The leasehold improvements should be depreciated (amortized) over their estimated useful lives or the term of the lease, whichever is shorter. The unamortized portion of the leasehold improvements could be included as a separate caption in the property, plant, and equipment section or the intangible assets section of the balance sheet. The amortized portion of the leasehold improvements would be shown as an expense in the income statement.

M87

Answer 3 (10 points)

a. The insurance costs on the raw materials while they were in transit from the supplier should be accounted for as part of inventory. Theoretically, insurance cost on raw materials in transit is a cost associated with readying the goods for sale.

b. 1. Hanlon's inventory should be reported at net realizable value. According to the lower of cost or market rule, market is defined as replacement cost. However, market cannot exceed net realizable value. In this instance, net realizable value is below original cost.

2. The lower of cost or market rule is used to report the inventory in the balance sheet at its future utility value. It also recognizes a decline in the utility of inventory in the income statement in the period in which the decline occurs.

c. Generally, ending inventory would have been higher and cost of goods sold would have been lower had Hanlon used the LIFO inventory method. Inventory quantities increased and LIFO associates the oldest purchase prices with inventory. However, in this instance, there would have been no effect on ending inventory or cost of goods sold had Hanlon used the LIFO inventory method, because Hanlon's ending inventory would have been reported at net realizable value according to the lower of cost or market rule. Net realizable value of the inventory is less than either its average cost or LIFO cost.

N86

Answer 2 (10 points)

a. The specific write-off method overstates the trade accounts receivable on the balance sheet by reporting them at more than their net realizable value. Furthermore, because the write-off often occurs in a period after the revenues were generated, the specific write-off method does not match bad debts expense with the revenues generated by sales in the same period.

b. One allowance method estimates bad debts based on credit sales. The method focuses on the income statement and attempts to match bad debts with the revenues generated by the sales in the same period.

The other allowance method estimates bad debts based on the balance in the trade accounts receivable

accounts. The method focuses on the balance sheet and attempts to value the accounts receivable at their future collectible amounts.

c. Anth should account for the collection of the specific accounts previously written off as uncollectible as follows:

- Correction of allowance account by debiting accounts receivable and crediting allowance for doubtful accounts.
- Collection of specific accounts previously written off as uncollectible by debiting cash and crediting accounts receivable.

d. Anth should report the face amount of the interest-bearing notes receivable and the related interest receivable for the period July 1, 1985, through December 31, 1986, on its December 31, 1986, balance sheet as current assets. Both assets are due on June 30, 1987, which is within one year of the date of the balance sheet.

Anth should report interest income from the notes receivable on its income statement for the year ended December 31, 1986. The interest income would be equal to the amount accrued on the notes receivable at the stated rate for twelve months. Interest accrues with the passage of time, and it should be accounted for as an element of income over the life of the notes receivable.

N85

Answer 2 (10 points)

a. The costs that should be capitalized when equipment is purchased for cash should include the gross invoice price of the equipment less discount plus all incidental costs relating to its purchase or preparation for use. Any available discounts whether taken or not should be deducted from the gross invoice price of the equipment.

For equipment purchased under a long-term payment plan, the amount capitalized is the same as for equipment purchased for cash, i.e., the capitalizable cost represents the cash equivalent price. The interest charges should not be capitalized.

b. The physical factors that cause the equipment to depreciate are wear and tear from operation, action of time and other elements, and deterioration and decay. The functional factors that cause the equipment to depreciate are inadequacy, obsolescence, and supersession.

c. The factors that should be considered in computing depreciation expense are the cost of the asset, the estimated residual (salvage) value, and the allocation over the estimated service life of the asset by a systematic and rational allocation procedure.

d. Accelerated depreciation methods are justified based on the following assumptions:

- An asset is more efficient in the earlier years of its estimated useful life. Therefore, larger depreciation charges in the earlier years would be matched against the larger revenues generated in the earlier years.
- Repair expenses on an asset increase in the later years of its estimated useful life. Therefore, smaller depreciation charges in the later years would be combined with the larger repair expenses incurred in the later years resulting in a smooth or level pattern of these expenses.

N85

Answer 3 (10 points)

a. Purchases from various suppliers should generally be included in Caddell's inventory when Caddell receives the goods. For accounting purposes, in the absence of other information, title to goods purchased FOB destination is assumed to pass when the goods are received.

b. Caddell should account for the warehousing costs as additional cost of inventory. Theoretically, warehousing is a cost of readying the goods for sale and should be included in inventory cost.

c. 1. The advantages of using the dollar value LIFO inventory cost flow method are to reduce the cost of accounting for inventory according to the LIFO method and to minimize the probability of unintentional liquidation of LIFO inventory.

2. The calculation of dollar value LIFO is based on dollars of inventory, a specific price index for each year, and broad inventory pools, whereas the conventional quantity of goods method is applied to individual units of each separate product. The inventory layers are identified with the price index for the year in which the layer was added.

d. Caddell should account for the inventories consigned to Reed Company as part of inventory. Caddell retains title to the goods until their sale by Reed; therefore, the earnings process has not been completed.

e. In applying the lower of cost or market method, market should not exceed the ceiling or fall below the floor. The ceiling is equal to the net realizable value, i.e., estimated selling price in the ordinary course of business less reasonably predictable costs of completion and disposal. The floor is equal to the net realizable value reduced by an allowance for an approximately normal profit margin.

N85

Answer 4 (10 points)

a. A noncurrent marketable equity securities portfolio should be accounted for at cost or market, whichever is lower. Therefore, at the end of the year Walker should report the noncurrent marketable equity securities

portfolio as a noncurrent asset at market. It is conservative to carry the portfolio at market value when it is below cost because of the uncertainty of future recovery of the market decline. The amount by which the aggregate cost of the portfolio exceeded the market value at the end of the year should be accounted for as a valuation allowance to the portfolio. The offsetting portion of the entry is included in the equity section of the balance sheet and shown separately. The rationale for this treatment is that a decline in market value of an equity security classified as a noncurrent asset can be viewed as temporary and thus is not reflected in net income because the probability of realization of the loss is small.

Walker should report the cash dividends received during the year on the securities in the noncurrent marketable equity securities portfolio as dividend income.

b. Due to the size of its investment, i.e., over twenty percent of the outstanding voting stock of Sipe, Walker is presumed to be able to exercise significant influence over Sipe. Therefore, Walker should use the equity method of accounting for its investment in Sipe.

Walker should report the purchase of the stock of Sipe as a long-term investment, and initially account for it at cost, which is the amount of cash paid. The cash dividends received during the year by Walker on the investment in the stock of Sipe should be deducted from the carrying amount of the investment and have no effect on Walker's income statement.

Subsequent to the acquisition, Walker should report thirty-five percent of Sipe's earnings after the acquisition date as revenue in its income statement and add the same amount to the carrying amount of its investment on the balance sheet. This amount should be modified by adjustments similar to those made in preparing consolidated statements, including adjustments to eliminate intercompany gains and losses, and to amortize, if appropriate, any difference between Walker's cost and the underlying equity in net assets of Sipe on the acquisition date.

M85

Answer 3 (10 points)

a. 1. For the interest-bearing note receivable, the interest income for 1984 should be determined by multiplying the principal (face) amount of the note by the note's rate of interest by one half (July 1, 1984, to December 31, 1984). Interest accrues with the passage of time, and it should be accounted for as an element of income over the life of the note receivable.

2. For the non-interest-bearing note receivable, the interest income for 1984 should be determined by multiplying the carrying value of the note by the prevailing rate of interest at the date of the note by one third (September 1, 1984, to December 31, 1984). The carrying value of the note at September 1, 1984, is the maturity amount discounted for two years at the prevailing interest rate from the maturity date of August 31, 1986, back to the issuance date of September 1,

Accounting Theory

1984. Interest, even if unstated, accrues with the passage of time, and it should be accounted for as an element of income over the life of the note receivable.

b. The interest-bearing note receivable should be reported at December 31, 1984, as a current asset at its principal (face) amount.

The non-interest-bearing note receivable should be reported at December 31, 1984, as a noncurrent asset at its face amount less the unamortized discount on the note at December 31, 1984.

c. Because the trade accounts receivable are assigned on a with-recourse, nonnotification basis, Marie is responsible for collection and assumes the risks of any losses. Marie should account for the subsequent collections on the assigned trade accounts receivable by

debiting cash and crediting accounts receivable assigned. The cash collected should then be remitted to Daniel Finance until the amount advanced by Daniel Finance is settled. The payments to Daniel Finance consist of both principal and interest with interest computed at the rate of 20 percent on the balance outstanding.

d. Because the trade accounts receivable were factored on a without-recourse basis, the factor is responsible for collection. On November 1, 1984, Marie should credit accounts receivable for the amount of trade accounts receivable factored, debit cash for the amount received from the factor, debit a receivable from the factor for 5 percent of the trade accounts receivable factored, and debit finance charges (an expense) for 3 percent of the trade accounts receivable factored.

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles

M89

Answer 4 (10 points)

a. The issue price of the bond is determined by calculating the present value of all expected future cash outflows discounted at the effective interest rate (yield) of 10%. The issue price is the sum of the present value of the bonds' maturity amount (face value) plus the present value of the series of future interest payments.

b. 1. The 9% bonds were issued at a discount (less than face value). Although the bonds provide for the payment of interest at 9% of face value, 9% was less than the prevailing or market rate. Thus, in order to provide a yield of 10% to investors, the bonds must have been issued at a discount.

2. The amount of interest expense would be higher in the second year than in the first year. According to the effective interest method of amortization, the 10% effective interest rate is applied to an increasing bond carrying amount, which results in a higher interest expense in each successive year.

c. The proceeds from the issuance of the 8% non-convertible bonds with detachable stock purchase warrants should be allocated between the bonds and the warrants on the basis of their relative fair market values. The portion of the proceeds allocable to the bonds should be accounted for as long-term debt, while the portion allocable to the warrants should be accounted for as paid-in capital.

M89

Answer 5 (10 points)

a. The economic effects of a long-term capital lease on the lessee are similar to that of an equipment purchase using installment debt. Such a lease transfers substantially all of the benefits and risks incident to the ownership of property to the lessee, and obligates the lessee in a manner similar to that created when funds are borrowed. To enhance comparability between a firm that purchases an asset on a long-term basis and a firm that leases an asset under substantially equivalent terms, the lease should be capitalized.

b. A lessee should account for a capital lease at its inception as an asset and an obligation at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding any portion of the payments representing executory costs, together with any profit thereon. However, if the present value exceeds the fair value of the leased property at the inception of the lease, the amount recorded for the asset and obligation should be the fair value.

c. A lessee should allocate each minimum lease payment between a reduction of the obligation and interest expense so as to produce a constant periodic rate of interest on the remaining balance of the obligation.

d. Von should classify the first lease as a capital lease because the lease term is more than 75 percent of the estimated economic life of the machine. Von should classify the second lease as a capital lease because the lease contains a bargain purchase option.

N88

Answer 4 (10 points)

a. Skinner should report the potential costs due to the discovery of a possible product defect as an expense or loss in the income statement and as a liability in the balance sheet. In addition, Skinner should disclose the nature of the costs due to the discovery of a possible product defect.

Accrual and disclosure are required if both of the following conditions are met:

- It is considered probable that a liability has been incurred.
- The amount of loss can be reasonably estimated.

In this case both conditions are met.

b. Skinner should not report the potential claim for damages that may be received next year in the current year's income statement or balance sheet. Gain contingencies usually are not recorded in the accounts in advance of their realization. However, adequate disclosure should be made of gain contingencies, but care should be exercised to avoid misleading implications as to the likelihood of realization.

c. This year, Skinner should account for the potential costs due to the promotion campaign as a premium expense and as a liability for 70 percent of the dollar amount of the coupons issued. The amount of the liability at the end of this year would be 30 percent of the dollar amount of the coupons issued. This amount represents 70 percent of the dollar amount of the coupons issued this year less 40 percent of the dollar amount of the coupons redeemed and for which cash refunds were sent.

M88

Answer 4 (10 points)

a. The economic effect of a long-term capital lease on the lessee is similar to that of an installment purchase. Such a lease transfers substantially all of the benefits and risks incident to the ownership of property to the lessee. Therefore, the lease should be capitalized.

b. 1. Metcalf should account for the sale portion of the sale-leaseback transaction at January 1, 1987, by recording cash for the sale price, decreasing equipment at the undepreciated cost (net carrying amount) of the equipment, and establishing a deferred gain on sale-leaseback for the excess of the sale price of the equipment over its undepreciated cost (net carrying amount).

2. Metcalf should account for the leaseback portion of the sale-leaseback transaction at January 1, 1987, by recording both an asset and a liability at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding any portion of the payments representing executory costs, together with any profit.

However, if the present value exceeds the fair value of the leased equipment at January 1, 1987, the amount recorded for the asset and liability should be the equipment's fair value.

c. The deferred gain should be amortized over the lease term or life of asset, whichever is appropriate. During the first year of the lease, the amortization will be an amount proportionate to the amortization of the asset. This deferral and amortization method for a sale-leaseback transaction is required because the sale and the leaseback are two components of a single transaction rather than two independent transactions. Because of this interdependence of the sale and leaseback portions of the transaction, the gain should be deferred and amortized over the lease term.

N87

Answer 4 (10 points)

a. Spackenkill should report the potential costs due to the discovery of a safety hazard as an expense or loss in the income statement and as a liability in the balance sheet because both of the following conditions for accrual are met:

- It is considered probable that a liability has been incurred.
- The amount of loss can be reasonably estimated.

In addition, Spackenkill should disclose the nature of the costs due to the discovery of a safety hazard in the notes to the financial statements.

b. Spackenkill should disclose the nature of the potential costs of warranty costs in the notes to the financial statements. The disclosure should include a statement that an estimate of the possible loss or range of loss cannot be made.

Spackenkill should not report the warranty costs as an expense in the income statement nor as a liability in the balance sheet. Although the warranty costs are probable, they cannot be reasonably estimated.

c. Spackenkill should disclose the nature of the potential costs due to the discovery of a possible product defect in the notes to the financial statements. The disclosure should include an estimate of the possible loss or range of loss.

Spackenkill should not report the costs due to the discovery of a possible product defect as an expense or loss in the income statement nor as a liability in the balance sheet. Although the costs due to the discovery of a possible product defect can be reasonably estimated, they are not probable.

N87

Answer 5 (10 points)

a. 1. The 11% bonds were issued at a premium (more than face value). Although the bonds provide for the payment of interest of 11% of face value, this

rate was more than the prevailing or market rate for bonds of similar quality at the time the bonds were issued. Thus, the bonds must sell at a premium to yield 9%.

2. The amount of interest expense would be higher in the first year of the life of the bond issue than in the second year of the life of the bond issue. According to the effective interest method of amortization, the 9% effective interest rate is applied to a declining bond carrying amount, and results in a lower interest expense in each successive year.

b. 1. Gain or loss on early extinguishment of debt should be determined by comparing the net carrying amount of the bonds at the date of extinguishment with the reacquisition price. If the net carrying amount exceeds the reacquisition price, a gain results. If the net carrying amount is less than the reacquisition price, a loss results.

In this case, a gain results. The bonds were issued at a premium, therefore, the carrying amount of the bonds at the date of extinguishment must exceed face value. Thus, the net carrying amount exceeds the reacquisition price.

2. Brewster should report the gain on the early extinguishment in net income for 1986, as an extraordinary item, net of related income tax effect.

c. 1. Net income is not affected by conversion under the book value method. The book value method views the convertible bonds as possessing substantial characteristics of equity capital. The conversion represents the completion of a prior transaction (the issuance of the convertible debt), not the culmination of an earning process.

2. A gain or loss results, and thus net income is affected by conversion under the market value method when market value differs from the carrying amount of the convertible bonds. The market value method views the convertible bonds primarily as debt whose conversion was a significant economic transaction. The conversion represents the culmination of an earning process. The market value method views the market value of the common stock at the date of the conversion to be the proper measurement at which to carry the common stock.

N86

Answer 3 (10 points)

a. Hendrick should classify each lease as a capital lease. A capital lease transfers substantially all of the benefits and risks inherent to the ownership of property. In order for a lease to qualify as a capital lease for a lessee, it must meet at its inception one or more of the four criteria established by the Financial Accounting Standards Board.

The first lease is a capital lease because it transfers ownership of the machine to the lessee, Hendrick, by the end of the lease term.

The second lease is also a capital lease because it contains a bargain purchase option.

b. A lessee should report a capital lease on its balance sheet as a noncurrent asset and related liability under lease obligations. The noncurrent asset should be reported at its capitalized cost less accumulated amortization. The liability would be reported at an amount equal to the capitalized cost of the asset reduced by the principal portion of minimum lease payments made by the lessee. In addition, the liability would be appropriately classified as current and long-term debt.

A lessee should report on its income statement amortization which has been determined in a manner consistent with the lessee's normal depreciation policy for owned assets. A lessee should also report as an expense on its income statement the interest portion of the minimum lease payment.

The minimum lease payment should be allocated between a reduction of the liability on the balance sheet and interest expense on the income statement, in a manner which produces a constant periodic rate of interest on the remaining balance of the liability.

c. Normally, operating lease payments should be charged to expense on the income statement over the lease term on a straight-line basis. Therefore, a leased asset and its related obligation should not be reported on the lessee's balance sheet.

N86

Answer 4 (10 points)

a. Cope should report the probable warranty costs as an expense in the income statement and a liability in the balance sheet because both of the following required conditions for accrual were met:

- It is considered probable that liabilities have been incurred.
- The amount of loss can be reasonably estimated.

In addition, it may be necessary for Cope to disclose the nature of the probable warranty costs in the notes to the financial statements.

b. Cope should disclose the nature of the threat of expropriation of assets in the notes to the financial statements. In addition, an estimate of the possible loss or range of loss should be disclosed in the notes to the financial statements.

Cope should not report the threat of expropriation of assets as an expense in the income statement nor as a liability in the balance sheet because it does not meet both required conditions for accrual. The actual expropriation of assets is only reasonably possible instead of probable.

c. Adequate disclosure should be made of contingencies that result in gains, but care should be exercised to avoid misleading implications as to the likelihood of realization.

Cope should not report this year the probable damages that may be received next year as a gain in the

Unofficial Answers

income statement nor as an asset in the balance sheet. Gain contingencies usually are not recorded in the accounts until the gains are realized.

M86

Answer 5 (10 points)

a. The 11% term bonds were sold at a discount (less than face value) because the effective annual interest rate (yield) of 12% was higher than the stated interest rate of 11%. The bonds provide for the payment of interest of 11%; however, this rate was less than the prevailing or market rate for bonds of similar quality at the time the issue was sold. Therefore, the market value of the bonds at the date of sale must be less than face value so that investors may receive the effective annual interest rate (yield) on their investments.

b. In a balance sheet prepared immediately after the term bond issue was sold, a noncurrent liability, term bonds payable, would be presented at an amount equal to the face value of the bonds less the discount. At December 31, 1985, a noncurrent liability, term bonds payable, would be presented in the balance sheet at the face value of the bonds, less the unamortized discount. Therefore, the amortization of bond discount for November and December 1985 would increase the amount of term bonds payable, net of discount.

The bond issue costs incurred in preparing and selling the bond issue could be presented in one of three ways in a balance sheet prepared immediately after the term bond issue was sold:

- Noncurrent asset, deferred charge
- Reduction of the noncurrent liability, term bonds payable
- Not presented in balance sheet (expensed as incurred in 1985).

At December 31, 1985, the bond issue costs could be presented in one of three ways:

- If the bond issue costs were presented in the balance sheet as a noncurrent asset, deferred charge, the amortization of bond issue costs for November and December 1985 would decrease the amount of the deferred charge.
- If the bond issue costs were presented in the balance sheet as a reduction of the noncurrent liability, term bonds payable, the amortization of bond issue costs for November and December 1985 would increase the amount of the term bonds payable, net of discount.
- If the bond issue costs were expensed as incurred in 1985, there would be no effect from the date the term bond issue was sold to December 31, 1985.

A current liability, accrued interest payable, would be presented in a balance sheet prepared immediately after the term bond issue was sold for accrued interest received for October 1985. At December 31, 1985, the

accrued interest payable would include accrued interest received for October 1985 and accrued interest for November and December 1985.

c. 1. Bond discount for bonds sold between interest dates should be amortized over the period the bonds will be outstanding, that is, the period from the date of sale (November 1, 1985) to the maturity date (October 1, 1990).

2. The straight-line method of amortization provides an even dollar amount of amortization each year allocated over the period the bonds are outstanding. The interest method of amortization provides for an increasing dollar amount of amortization each year.

3. The interest method of amortization is preferable to the straight-line method because it provides a constant interest rate when applied to the increasing carrying value.

d. The proceeds from the sale of the 9% nonconvertible bonds with detachable stock purchase warrants should be accounted for as paid-in capital and long-term debt. Because the detachable stock purchase warrants are equity instruments which have a separate fair value at the issue date, the portion of the proceeds allocable to the warrants should be accounted for as paid-in capital. Because the bonds are debt instruments, the remainder of the proceeds, including the premium, should be accounted for as long-term debt.

M85

Answer 2 (10 points)

a. When a lease transfers substantially all of the benefits and risks incident to the ownership of property to the lessee, it should be capitalized by the lessee. The economic effect of such a lease on the lessee is similar, in many respects, to that of an installment purchase.

b. Lani should account for this lease at its inception as an asset and an obligation at an amount equal to the present value at the beginning of the lease term of minimum lease payments during the lease term, excluding that portion of the payments representing executory costs, together with any profit thereon. However, if the amount so determined exceeds the fair value of the leased machine at the inception of the lease, the amount recorded as the asset and obligation should be the machine's fair value.

c. Lani will incur interest expense equal to the interest rate used to capitalize the lease at its inception multiplied by the appropriate net carrying value of the liability.

In addition, Lani will incur an expense relating to amortization of the capitalized cost of the leased asset. This amortization should be based on the estimated useful life of the leased asset and amortized in a manner consistent with Lani's normal depreciation policy for owned assets.

d. The asset recorded under the capital lease and the accumulated amortization should be reported on Lani's December 31, 1984, balance sheet classified as non-current and should be separately identified by Lani in its balance sheet or footnotes thereto. The related obligation recorded under the capital lease should be reported on Lani's December 31, 1984, balance sheet appropriately classified into current and noncurrent categories and should be separately identified by Lani in its balance sheet.

M85

Answer 4 (10 points)

a. The market price of the term bonds would be the sum of the present values of all of the expected net future cash flows discounted at an effective annual interest rate (yield) of 10 percent. The net future cash outflows are the maturity amount (face value) and the series of future semiannual interest payments adjusted for accrued interest received.

The market price of the serial bonds would be determined by computing the market price for each serial separately in the same way that a term bond would be determined and then totaling these prices for the various serials.

b. 1. Immediately after the term bond issue was sold, the current asset—cash—would be increased by the proceeds from the sale of the term bond issue. A noncurrent liability—term bonds payable—would be presented in the balance sheet at the face value of the term bonds, plus the premium. In addition, a current

liability—accrued interest payable—would be presented in the balance sheet for accrued interest received (September 1, 1984, to October 1, 1984).

2. Immediately after the serial bond issue was sold, the current asset—cash—would be increased by the proceeds from the sale of the serial bond issue. A noncurrent liability—serial bonds payable—would be presented in the balance sheet at the face value of the serial bonds, less the discount.

c. The bond issue costs incurred in preparing and selling the bond issue could be accounted for as a non-current asset—deferred charge. The bond issue cost would then be amortized over the period the bonds will be outstanding, that is, the period from the date of sale (October 1, 1984) to the maturity date (March 1, 1989).

Alternately, under Statements of Financial Accounting Concepts, the bond issue costs incurred in preparing and selling the bond issue could be either accounted for as an expense in 1984, or as a reduction of the noncurrent liability—term bonds payable—and accounted for the same as debt discount.

d. To determine the amount of interest expense for the term bonds for 1984, the net carrying value of the term bonds on October 1, 1984, would be multiplied by the effective interest rate (yield) of 10 percent by one fourth (October 1, 1984, to December 31, 1984).

To determine the amount of interest expense for the serial bonds for 1984, the net carrying value of the serial bonds on November 1, 1984, would be multiplied by the effective interest rate (yield) of 11 percent by one sixth (November 1, 1984, to December 31, 1984).

IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles

N85

Answer 5 (10 points)

a. Brady should account for the purchase of the treasury stock on August 15, 1984, by debiting treasury stock and crediting cash for the cost of the purchase (1,000 shares \times \$12 per share). Brady should account for the sale of the treasury stock on September 14, 1984, by debiting cash for the selling price (500 shares \times \$14 per share), crediting treasury stock for cost (500 shares \times \$12 per share), and crediting additional paid-in capital from treasury stock transactions for the excess of the selling price over the cost (500 shares \times \$2 per share). The remaining treasury stock (500 shares \times \$12 per share) should be presented separately in the stockholders' equity section of Brady's December 31, 1984, balance sheet as an unallocated reduction of stockholders' equity. These shares are considered issued but not part of common stock outstanding.

b. Brady should account for the stock dividend by debiting retained earnings for \$16 per share (the market value of the stock in October 1984, the date of the stock dividend) multiplied by the 2,000 shares distributed. Brady should then credit common stock for the par value of the common stock (\$10 per share) multiplied by the 2,000 shares distributed, and credit additional paid-in capital for the excess of the market value (\$16 per share) over the par value (\$10 per share) multiplied by the 2,000 shares distributed. Total stockholders' equity does not change, but, because this is considered a small stock dividend, recognition has been made of a capitalization of retained earnings equivalent to the market value of the additional shares resulting from the stock dividend.

c. Brady should account for the cash dividend on December 20, 1984, the declaration date, by debiting retained earnings and crediting cash dividends payable

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for \$1 per share multiplied by the number of shares outstanding. A cash dividend is a distribution to the corporation's stockholders. The liability for this distribution is incurred on the declaration date, and it is a current liability because it is payable within one year

(January 10, 1985). The effect of the cash dividend on Brady's balance sheet at December 31, 1984, is an increase in current liabilities and a decrease in retained earnings.

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles

M88

Answer 3 (10 points)

a. A change from the sum-of-the-years'-digits method of depreciation to the straight-line method for previously recorded assets is a change in accounting principle. Both the sum-of-the-years'-digits method and the straight-line method are generally accepted. A change in accounting principle results from adoption of a generally accepted accounting principle different from the generally accepted accounting principle used previously for reporting purposes.

b. A change in the expected service life of an asset arising because of more experience with the asset is a change in accounting estimate. A change in accounting estimate occurs because future events and their effects cannot be perceived with certainty. Estimates are an inherent part of the accounting process. Therefore, accounting and reporting for certain financial statement elements requires the exercise of judgment, subject to revision based on experience.

c. 1. The cumulative effect of a change in accounting principle is the difference between (1) the amount of retained earnings at the beginning of the period of change and (2) the amount of retained earnings that would have been reported at that date if the new accounting principle had been used in prior periods.

2. The cumulative effect, net of income taxes, should be shown as a separate item in the income statement for the period of change between the captions "extraordinary items" and "net income". Pro-forma disclosure of the effects of retroactive restatement should be shown on the face of the income statement.

d. 1. Consistent use of accounting principles from one accounting period to another enhances the utility of financial statements to users of comparative accounting data.

2. If a change in accounting principle occurs, the nature and effect of a change in accounting principle should be disclosed to avoid misleading financial statement users. There is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type.

M88

Answer 5 (10 points)

a. The two accounting problems resulting from the nature of the defined benefit pension plan are as follows:

- Estimates or assumptions must be made concerning the future events that will determine the amount and timing of the benefit payments.
- Some approach to attributing the cost of pension benefits to individual years of service must be selected.

The two problems arise because a company must recognize pension costs before it pays pension benefits.

b. Carson should determine the service cost component of the net pension cost as the actuarial present value of pension benefits attributable to employee services during a particular period based on the application of the pension benefit formula.

c. Carson should determine the interest cost component of the net pension cost as the increase in the projected benefit obligation due to the passage of time. Measuring the projected benefit obligation requires accrual of an interest cost at an assumed discount rate.

d. Carson should determine the actual return on plan assets component of the net pension cost as the change in the fair value of plan assets during the period, adjusted for (1) contributions and (2) benefit payments.

M87

Answer 4 (10 points)

a. Lynn should report the results of discontinued operations separately from continuing operations. Discontinued operations should be shown on Lynn's income statement immediately below the continuing operations section.

Discontinued operations reported in the income statement should be composed of two separate categories, with each category shown net of income taxes.

- Loss from operations of the discontinued segment from the beginning of the year to the measurement date.

Accounting Theory

- Loss on disposal of the discontinued segment, including the provision for operating losses during the phase-out period.
- b. Both of the following criteria should be met for classification as an extraordinary item. An extraordinary item should be unusual in nature and infrequent in occurrence, taking into account the environment in which the entity operates.
- c. First, the extraordinary loss should be shown as a separate item in the income statement below discontinued operations and above cumulative effect of accounting changes. Second, the extraordinary loss should be shown net of applicable income taxes.

N86

Answer 5 (10 points)

- a. Wesley's compensation expense for 1983 should be one half of the excess of the quoted market price over the option price on January 1, 1983, for those shares on which stock options were granted.

Wesley's compensation expense for 1984 should be one half of the excess of the quoted market price over the option price on January 1, 1983, for those shares on which stock options were granted.

Wesley should not report compensation expense related to the compensatory stock options for 1985.

Compensation expense should be recognized in the income statement of each period in which services are rendered. This procedure relates the compensation expense with the revenues in conformity with the matching principle.

- b. Wesley should account for the exercise of the stock options as follows:

- Debit contributed capital—stock options for one half of the amount originally credited to that account on January 1, 1983.
- Debit cash for the proceeds received, which represents the number of shares exercised multiplied by the option price on January 1, 1983.
- Credit common stock for the par value of the stock, and credit contributed capital in excess of par—common for the difference. The objective of this accounting is to assign the appropriate value to contributed capital for common stock issued. That value is the sum of the cash proceeds and the amount that had been assigned originally to contributed capital—stock options for those shares issued.

- c. Wesley should account for the lapse of the stock options as follows:

- Debit contributed capital—stock options for one half of the amount originally credited to that account on January 1, 1983.
- Credit contributed capital—expired stock options for the same amount.

This entry reclassifies the expired stock options to contributed capital—expired stock options. Compensation expense is not altered by the fact that some stock options were allowed to lapse.

M86

Answer 2 (10 points)

- a. 1. The percentage-of-completion method is justified because revenue is earned as work is performed under the long-term construction contract. As a result, it provides more relevant information. Revenues represent actual or expected cash inflows (or the equivalent) that have occurred or will eventuate as a result of the enterprise's ongoing major or central operations during the period.

2. Village Company should account for this long-term construction contract using the percentage-of-completion method because this method is preferable when estimates of costs to complete and extent of progress toward completion are reasonably dependable. The facts in the situation also indicate that the right to revenue is established and collectibility assured.

- b. The income recognized in each year of this long-term construction contract would be determined using the cost-to-cost method of determining percentage of completion as follows:

- The contract price is the first part of the determination of the total estimated income for each year. The total actual costs (the second part of the determination of the total estimated income for each year) represent all costs incurred from the inception of the project to the end of the current year.
- The estimated total costs (the third part of the determination of the total estimated income for each year) are subtracted from the contract price to arrive at the estimated total income. The estimated total costs consist of the actual costs to date and the estimated costs to complete the contract and would generally change each year.
- The income recognized in the first year would be the percentage of the actual costs to date to the estimated total costs multiplied by the estimated total income. The income recognized in the second (third) year would be the percentage of the actual costs to date to the estimated total costs multiplied by the estimated total income less the income already recognized in the first (first and second) year.

- c. Progress billings sent and collections on these billings would not affect the income recognized in each year of this long-term contract.

M86

Answer 3 (10 points)

- a. Berkeley's change in depreciation method is a change in accounting principle. This change in accounting principle should show the cumulative effect of a

Unofficial Answers

change in accounting principle in net income of the period of change, and the pro forma effects of retroactive application. This change in accounting principle should not be reported by restating the financial statements of prior periods.

Berkeley's change in salvage values is a change in accounting estimate. This change in accounting estimate should not show the cumulative effect of a change in accounting principle in net income of the period of change, nor should Berkeley show the pro forma effects of retroactive application. Furthermore, this change in accounting estimate should not be reported by restating the financial statements of prior periods.

Berkeley's change in the specific subsidiaries comprising the group of companies for which consolidated financial statements are presented is a change in reporting entity. This change in reporting entity should

not show the cumulative effect of a change in accounting principle in net income of the period of change, nor should Berkeley show the pro forma effects of retroactive application. However, this change in reporting entity should be reported by restating the financial statements of prior periods.

b. Consistent use of accounting principles from one accounting period to another enhances the utility of financial statements to users by facilitating analysis and understanding of comparative accounting data. There is a presumption that an accounting principle once adopted should not be changed in accounting for events and transactions of a similar type. The presumption that a company should not change an accounting principle may be overcome only if the company justifies the use of an alternative acceptable accounting principle on the basis that it is preferable.

VI. Other Financial Topics

N88

Answer 5 (10 points)

a. 1. A business combination accounted for as a purchase is an arms-length transaction in which one company acquires another company. The purchased company is treated as an acquired asset and is recorded at its cost to the acquiring company. Therefore, a new basis of accounting is established for the net assets of the acquired company.

2. All identifiable assets acquired and liabilities assumed in a business combination should be recorded at their fair values at date of acquisition. If the cost of the acquired company exceeds the fair value of the identifiable net assets acquired, the excess should be recorded as goodwill.

3. Goodwill should be amortized by charges to income over the periods estimated to be benefited. The period of amortization should not, however, exceed 40 years. The straight-line method of amortization should be applied unless a company demonstrates that another systematic method is more appropriate.

b. 1. A business combination accounted for as a pooling of interests is a combination of ownership interests of previously separate companies. As a result, the existing basis of accounting continues for both companies.

2. In a pooling of interests, the carrying amount of stockholders' equities of the separate companies are combined. Normally, the combined corporation records as contributed capital the capital stock and capital in excess of par or stated value of outstanding stock of the separate companies. Similarly, retained earnings or deficits of the separate companies are combined and recognized as retained earnings of the combined corporation.

The amount of outstanding shares of stock of the combined corporation at par or stated value may exceed the total amount of capital stock of the combining companies. The excess should be deducted first from the combined other contributed capital and then from the combined retained earnings.

M87

Answer 5 (10 points)

a. 1. In a pooling of interests, the recorded amounts of the assets and liabilities of the separate companies generally become the recorded amounts of the assets and liabilities of the combined corporation. The existing basis of accounting continues. A pooling of interests transaction is regarded as an arrangement among stockholder groups.

2. In a pooling of interests, the registration fees and direct costs related to effecting the business combination should be deducted in determining the net income of the resulting combined corporation for the period in which the expenses are incurred.

3. In a pooling of interests, the results of operations for the year in which the business combination occurred should be reported as though the companies had been combined as of the beginning of the year.

b. 1. In a purchase, the acquiring corporation should allocate the cost of the acquired company to the assets acquired and liabilities assumed. All identifiable assets acquired and liabilities assumed in the business combination should be recorded at their fair values at date of acquisition. The excess of the cost of the acquired company over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed should be recorded as goodwill. A purchase transaction is regarded as a bargained transaction (i.e., a significant

Accounting Theory

economic event which results from bargaining between independent parties) which establishes a new basis of accounting.

2. In a purchase, the registration fees related to effecting the business combination are a reduction of the otherwise determinable fair value of the securities, (usually as a reduction of paid of capital). The direct costs related to effecting the business combination are included as part of the acquisition cost of the acquired company.

3. In a purchase, the results of operations for the year in which the business combination occurred should include income of the acquired company after the date of acquisition by including the revenues and expenses of the acquired company based on the cost to the acquiring corporation.

M86

Answer 4 (10 points)

a. 1. Goodwill does not arise and, therefore, should not be reported if the business combination is accounted for as a pooling of interests. The recorded assets and liabilities of the separate companies generally become the recorded assets and liabilities of the combined corporation.

However, goodwill should be reported if the business combination is accounted for as a purchase.

2. All identifiable assets acquired, either individually or by type, and liabilities assumed in a business

combination, whether or not shown in the financial statements of Moore, should be assigned a portion of the cost of Moore, normally equal to their fair values at date of acquisition. Then, the excess of the cost of Moore over the sum of the amounts assigned to identifiable assets acquired less liabilities assumed should be recorded as goodwill.

3. Minority interest should be reported whether the business combination is accounted for as a purchase or a pooling of interests. The amount of minority interest reported would be the same whether the business combination is accounted for as a purchase or a pooling of interests.

b. 1. Consolidated financial statements should be prepared in order to present financial position and operating results in a manner more meaningful than in separate statements.

2. The usual first necessary condition for consolidation is control as evidenced by ownership of a majority voting interest. Therefore, as a general rule, ownership by one company, directly or indirectly, of over fifty percent of the outstanding voting shares of another company is a condition necessary for consolidation.

3. Consolidated financial statements should be prepared whether a business combination is accounted for as a purchase or a pooling of interests. Control exists and is independent of the method of accounting used.

Uniform CPA Examination/May 1985 – May 1989

Auditing

**Selected Questions
And Unofficial Answers
Indexed To
Content Specification
Outline**




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MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. Professional Responsibilities

A. General Standards and Code of Professional Conduct

M89#2. Which of the following bodies promulgates standards for audits of federal financial assistance recipients?

- a. Governmental Accounting Standards Board.
- b. Financial Accounting Standards Board.
- c. General Accounting Office.
- d. Governmental Auditing Standards Board.

M89#3. According to the profession's ethical standards, an auditor would be considered independent in which of the following instances?

- a. The auditor's checking account, which is fully insured by a federal agency, is held at a client financial institution.
- b. The auditor is also an attorney who advises the client as its general counsel.
- c. An employee of the auditor donates service as treasurer of a charitable organization that is a client.
- d. The client owes the auditor fees for two consecutive annual audits.

M89#26. The concept of materiality would be **least** important to an auditor when considering the

- a. Effects of a direct financial interest in the client upon the CPA's independence.
- b. Decision whether to use positive or negative confirmations of accounts receivable.
- c. Adequacy of disclosure of a client's illegal act.
- d. Discovery of weaknesses in a client's internal control structure.

N88#1. An accountant who is **not** independent of a client is precluded from issuing a

- a. Compilation report on historical financial statements.
- b. Compilation report on prospective financial statements.
- c. Special report on compliance with contractual agreements.
- d. Report on management advisory services.

N88#2. Which of the following elements underlies the application of generally accepted auditing standards, particularly the standards of field work and reporting?

- a. Internal accounting control.
- b. Corroborating evidence.
- c. Quality control.
- d. Materiality and relative risk.

N88#3. Which of the following acts by a CPA who is **not** in public practice would most likely be considered a violation of the ethical standards of the profession?

- a. Using the CPA designation without disclosing employment status in connection with financial statements issued for external use by the CPA's employer.
- b. Distributing business cards indicating the CPA designation and the CPA's title and employer.
- c. Corresponding on the CPA's employer's letterhead, which contains the CPA designation and the CPA's employment status.
- d. Compiling the CPA's employer's financial statements and making reference to the CPA's lack of independence.

N88#4. The ethical standards of the profession would most likely be considered to be violated if a CPA

- a. Owns a building and leases a portion of the space to an audit client.
- b. Has an insured account with a brokerage firm that is an audit client and the account is used for occasional cash transactions.
- c. Is asked by an audit client to act as a "finder" in the acquisition of another company on a per diem basis.
- d. Searches for and initially screens candidates for the vacant controllership of an audit client.

N88#5. Which of the following statements best explains why the CPA profession has found it essential to promulgate ethical standards and to establish means for ensuring their observance?

- a. Vigorous enforcement of an established code of ethics is the best way to prevent unscrupulous acts.
- b. Ethical standards that emphasize excellence in performance over material rewards establish a reputation for competence and character.
- c. A distinguishing mark of a profession is its acceptance of responsibility to the public.
- d. A requirement for a profession is to establish ethical standards that stress primarily a responsibility to clients and colleagues.

Auditing

M88#51. The exercise of due professional care requires that an auditor

- a. Use error-free judgment.
- b. Study and review internal accounting control, including compliance tests.
- c. Critically review the work done at every level of supervision.
- d. Examine all corroborating evidence available.

M88#52. Under which of the following circumstances would the independence of a CPA be considered impaired if the CPA, who is also an attorney, serves as auditor and provides legal services to the same client?

- a. When the CPA, as legal agent, consummates a business acquisition for the client.
- b. When the CPA's audit fees and legal fees are **not** billed separately.
- c. When the CPA uses legal expertise to research a question of income tax law.
- d. When the legal services consist of an analysis of the terms of a lease agreement.

M88#53. A violation of the profession's ethical standards would most likely have occurred when a CPA

- a. Purchased a bookkeeping firm's practice of monthly write-ups for a percentage of fees received over a three-year period.
- b. Made arrangements with a bank to collect notes issued by a client in payment of fees due.
- c. Named Smith formed a partnership with two other CPAs and use "Smith & Co." as the firm name.
- d. Issued an unqualified opinion on the 1987 financial statements when fees for the 1986 audit were unpaid.

N87#17. Audits of certain governmental entities are required to be performed in accordance with generally accepted government auditing standards (GAGAS). These standards do **not** require, as part of an auditor's report, the identification of

- a. Significant internal accounting and administrative controls designed to provide reasonable assurance that federal programs are being administered in compliance with applicable laws and regulations.
- b. Material weaknesses discovered as a result of the study and evaluation of the internal control systems.
- c. Sampling methods used to test the internal controls designed to detect errors and irregularities.
- d. Significant internal accounting and administrative controls that were **not** evaluated, and the reasons why they were **not** evaluated.

N87#18. If requested to perform a review engagement for a nonpublic entity in which an accountant has an immaterial direct financial interest, the accountant is

- a. Not independent and, therefore, may issue a review report, but may **not** issue an auditor's opinion.
- b. Not independent and, therefore, may **not** issue a review report.
- c. Not independent and, therefore, may **not** be associated with the financial statements.
- d. Independent because the financial interest is immaterial and, therefore, may issue a review report.

N87#19. An auditor strives to achieve independence in appearance in order to

- a. Maintain public confidence in the profession.
- b. Become independent in fact.
- c. Comply with the generally accepted auditing standards of field work.
- d. Maintain an unbiased mental attitude.

N87#22. Which one of the following is an enforceable set of pronouncements of an authoritative body designated to establish accounting principles, according to the AICPA Code of Professional Ethics?

- a. AICPA Statements on Standards for Accounting and Review Services.
- b. AICPA Statements of Position.
- c. FASB Interpretations.
- d. FASB Statements of Financial Accounting Concepts.

M87#1. When performing an audit of a city that is subject to the requirements of the Uniform Single Audit Act of 1984, an auditor should adhere to

- a. Governmental Accounting Standards Board *General Standards*.
- b. Governmental Finance Officers Association *Governmental Accounting, Auditing, and Financial Reporting Principles*.
- c. General Accounting Office *Standards for Audit of Governmental Organizations, Programs, Activities, and Functions*.
- d. Securities and Exchange Commission *Regulation S-X*.

M87#29. Without the consent of the client, a CPA should **not** disclose confidential client information contained in working papers to a

- a. Voluntary quality control review board.
- b. CPA firm that has purchased the CPA's accounting practice.
- c. Federal court that has issued a valid subpoena.
- d. Disciplinary body created under state statute.

Selected Questions

N86#1. As guidance for measuring the quality of the performance of an auditor, the auditor should refer to

- a. Statements of the Financial Accounting Standards Board.
- b. Generally accepted auditing standards.
- c. Interpretations of the Statements on Auditing Standards.
- d. Statements on Quality Control Standards.

N86#4. The AICPA Code of Professional Ethics contains both general ethical principles that are aspirational in character and also a

- a. List of violations that would cause the automatic suspension of the CPA's license.
- b. Set of specific, mandatory rules describing minimum levels of conduct the CPA must maintain.
- c. Description of the CPA's procedures for responding to an inquiry from a trial board.
- d. List of specific crimes that would be considered as acts discreditable to the profession.

N86#6. A violation of the profession's ethical standards would **least** likely have occurred when a CPA in public practice

- a. Used a records-retention agency to store the CPA's working papers and client records.
- b. Served as an expert witness in a damage suit and received compensation based on the amount awarded to the plaintiff.
- c. Referred life insurance assignments to the CPA's spouse, who is a life insurance agent.
- d. Served simultaneously as state director of revenues and practiced public accounting in the same state.

N86#12. Which of the following is **not** required by the generally accepted auditing standard that states that due professional care is to be exercised in the performance of the examination?

- a. Observance of the standards of field work and reporting.
- b. Critical review of the audit work performed at every level of supervision.
- c. Degree of skill commonly possessed by others in the profession.
- d. Responsibility for losses because of errors of judgment.

M86#6. Which of the following legal situations would be considered to impair the auditor's independence?

- a. An expressed intention by the present management to commence litigation against the auditor alleging deficiencies in audit work for the client, although the auditor considers that there is only a remote possibility that such a claim will be filed.
- b. Actual litigation by the auditor against the client for an amount **not** material to the auditor or to the financial statements of the client arising out of disputes as to billings for management advisory services.

- c. Actual litigation by the auditor against the present management alleging management fraud or deceit.
- d. Actual litigation by the client against the auditor for an amount **not** material to the auditor or to the financial statements of the client arising out of disputes as to billings for tax services.

M86#16. A CPA purchased stock in a client corporation and placed it in a trust as an educational fund for the CPA's minor child. The trust securities were not material to the CPA but were material to the child's personal net worth. Would the independence of the CPA be considered to be impaired with respect to the client?

- a. Yes, because the stock would be considered a direct financial interest and, consequently, materiality is **not** a factor.
- b. Yes, because the stock would be considered an indirect financial interest that is material to the CPA's child.
- c. No, because the CPA would **not** be considered to have a direct financial interest in the client.
- d. No, because the CPA would **not** be considered to have a material indirect financial interest in the client.

M86#17. Which of the following best describes what is meant by generally accepted auditing standards?

- a. Pronouncements issued by the Auditing Standards Board.
- b. Procedures to be used to gather evidence to support financial statements.
- c. Rules acknowledged by the accounting profession because of their universal compliance.
- d. Measures of the quality of the auditor's performance.

M86#18. After beginning an audit of a new client, Larkin, CPA, discovers that the professional competence necessary for the engagement is lacking. Larkin informs management of the situation and recommends another CPA, and management engages the other CPA. Under these circumstances

- a. Larkin's lack of competence should be construed to be a violation of generally accepted auditing standards.
- b. Larkin may request compensation from the client for any professional services rendered to it in connection with the audit.
- c. Larkin's request for a commission from the other CPA is permitted because a more competent audit can now be performed.
- d. Larkin may be indebted to the other CPA since the other CPA can collect from the client only the amount the client originally agreed to pay Larkin.

Auditing

M86#19. A violation of the profession's ethical standards would most likely occur when a CPA who

- a. Is also admitted to the Bar represents on letterhead to be both an attorney and a CPA.
- b. Writes a newsletter on financial management also permits a publishing company to solicit subscriptions by direct mail.
- c. Is controller of a bank permits the bank to use the controller's CPA title in the listing of officers in its publications.
- d. Is the sole shareholder in a professional accountancy corporation uses the designation "and company" in the firm title.

M86#22. The profession's ethical standards would most likely be considered to have been violated when the CPA represents that specific consulting services will be performed for a stated fee and it is apparent at the time of the representation that the

- a. CPA would **not** be independent.
- b. Fee was a competitive bid.
- c. Actual fee would be substantially higher.
- d. Actual fee would be substantially lower than the fees charged by other CPAs for comparable services.

N85#1. Which of the following best describes what is meant by generally accepted auditing standards?

- a. Audit objectives generally determined on audit engagements.
- b. Acts to be performed by the auditor.
- c. Measures of the quality of the auditor's performance.
- d. Procedures to be used to gather evidence to support financial statements.

N85#2. When a CPA is requested to perform a review engagement for a nonpublic entity in which the CPA has an immaterial financial interest, the CPA should inform management that the CPA

- a. Will have to disclose the lack of independence in the review report.
- b. Lacks independence and, therefore, may issue a review report, but can **not** issue an auditor's opinion.
- c. Lacks independence and, therefore, is precluded from issuing a review report.
- d. Is considered independent because the financial interest is immaterial and, therefore, the CPA can issue a review report.

N85#4. In which of the following circumstances would a CPA who audits XM Corporation lack independence?

- a. The CPA and XM's president are both on the board of directors of COD Corporation.
- b. The CPA and XM's president each owns 25% of FOB Corporation, a closely held company.
- c. The CPA has a home mortgage from XM, which is a savings and loan organization.
- d. The CPA reduced XM's usual audit fee by 40% because XM's financial condition was unfavorable.

N85#7. Which of the following statements best describes why the CPA profession has deemed it essential to promulgate ethical standards and to establish means for ensuring their observance?

- a. A requirement for a profession is the establishment of ethical standards that stress primarily a responsibility to clients and colleagues.
- b. A requirement of most state laws calls for the profession to establish a code of ethics.
- c. An essential means of self-protection for the profession is the establishment of flexible ethical standards by the profession.
- d. A distinguishing mark of a profession is its acceptance of responsibility to the public.

N85#13. The first general standard recognizes that regardless of how capable an individual may be in other fields, the individual can **not** meet the requirements of the auditing standards without the proper

- a. Business and finance courses.
- b. Quality control and peer review.
- c. Education and experience in auditing.
- d. Supervision and review skills.

N85#14. The third general standard states that due care is to be exercised in the performance of the examination. This standard means that a CPA who undertakes an engagement assumes a duty to perform each audit

- a. As a professional possessing the degree of skill commonly possessed by others in the field.
- b. In conformity with generally accepted accounting principles.
- c. With reasonable diligence and without fault or error.
- d. To the satisfaction of governmental agencies and investors who rely upon the audit.

N85

Items 21 through 26* are based on the following information:

Hickory, Inc., is a small manufacturer. Its office building, plant, and warehouse are all located in Zena, Ohio. William Cream is the principal owner and president of Hickory.

Hickory is not a publicly-held corporation. The primary uses of the financial statements are for its 15 shareholders and for bank credit purposes. Hickory's financial statements have never been audited or reviewed.

On July 18, 1984, William Cream hired the CPA firm of Part & Co. to audit Hickory's financial statements for the year ended December 31, 1984. Part &

*The items omitted can be found in other Content Specification Groups.

Selected Questions

Co. performed the audit field work from December 15, 1984, through March 10, 1985.

Part & Co. has offices in Cleveland, the office that performed the Hickory audit, and Chicago.

26. In order for Part & Co. to be considered independent with respect to the Hickory audit, which of the following individuals would most likely be permitted to own an immaterial direct financial interest in Hickory?

- a. Professional employees at either office.
- b. Professional employees at the Chicago office.
- c. Professional employees and partners at the Chicago office.
- d. None of the professional employees or partners at either office.

M85#17. A client company has not paid its 1983 audit fees. According to the AICPA Code of Professional Ethics, for the auditor to be considered independent with respect to the 1984 audit, the 1983 audit fees must be paid before the

- a. 1983 report is issued.
- b. 1984 fieldwork is started.
- c. 1984 report is issued.
- d. 1985 fieldwork is started.

M85#28. The first general standard requires that the examination of financial statements is to be performed by a person or persons having adequate technical training and

- a. Independence with respect to the financial statements and supplementary disclosures.
- b. Exercising professional care as judged by peer reviewers.
- c. Proficiency as an auditor which likely has been acquired from previous experience.
- d. Objectivity as an auditor as verified by proper supervision.

M85#48. Which one of the following is **not** a pronouncement of an authoritative body designated by the AICPA Council to establish accounting principles, pursuant to the AICPA Code of Professional Ethics?

- a. AICPA Statements of Position.
- b. AICPA Accounting Principles Board Opinions.
- c. FASB Interpretations.
- d. FASB Statements of Financial Accounting Standards.

B. Control of the Audit

M89#4. A CPA firm's quality control procedures pertaining to the acceptance of a prospective audit client would most likely include

- a. Inquiry of management as to whether disagreements between the predecessor auditor and the prospective client were resolved satisfactorily.
- b. Consideration of whether sufficient competent evidential matter may be obtained to afford a reasonable basis for an opinion.

- c. Inquiry of third parties, such as the prospective client's bankers and attorneys, about information regarding the prospective client and its management.
- d. Consideration of whether the internal control structure is sufficiently effective to permit a reduction in the extent of required substantive tests.

M89#5. Which of the following audit risk components may be assessed in nonquantitative terms?

	<i>Inherent risk</i>	<i>Control risk</i>	<i>Detection risk</i>
a.	Yes	Yes	No
b.	Yes	No	Yes
c.	No	Yes	Yes
d.	Yes	Yes	Yes

N88#6. Which of the following procedures would an auditor most likely include in the initial planning of an examination of financial statements?

- a. Discussing the examination with firm personnel responsible for non-audit services to the client.
- b. Inquiring of the client's attorney as to any claims probable of assertion.
- c. Obtaining a written representation letter from management of the client.
- d. Determining whether necessary internal accounting control procedures are being applied as prescribed.

N88#7. The audit work performed by each assistant should be reviewed to determine whether it was adequately performed and to evaluate whether the

- a. Audit procedures performed are approved in the professional standards.
- b. Examination has been performed by persons having adequate technical training and proficiency as auditors.
- c. Auditor's system of quality control has been maintained at a high level.
- d. Results are consistent with the conclusions to be presented in the auditor's report.

N88#11. A CPA firm should establish procedures for conducting and supervising work at all organizational levels to provide reasonable assurance that the work performed meets the firm's standards of quality. To achieve this goal, the firm most likely would establish procedures for

- a. Evaluating prospective and continuing client relationships.
- b. Reviewing engagement working papers and reports.
- c. Requiring personnel to adhere to the applicable independence rules.
- d. Maintaining personnel files containing documentation related to the evaluation of personnel.

Auditing

N88#23. An auditor's document includes the following statement:

"Our audit is subject to the risk that errors, irregularities, or illegal acts, including fraud or defalcations, if they exist, will not be detected. However, we will inform you of any such matters that come to our attention."

The above passage is most likely from

- a. The explanatory paragraph of a "subject to" qualified auditor's report.
- b. An engagement letter.
- c. The explanatory paragraph of a compliance report on a governmental entity subject to GAO standards.
- d. A comfort letter.

N88#33. A basic objective of a CPA firm is to provide professional services that conform with professional standards. Reasonable assurance of achieving this basic objective is provided through

- a. Compliance with generally accepted reporting standards.
- b. A system of quality control.
- c. A system of peer review.
- d. Continuing professional education.

M88#54. Before accepting an audit engagement, a successor auditor should make specific inquiries of the predecessor auditor regarding the predecessor's

- a. Awareness of the consistency in the application of generally accepted accounting principles between periods.
- b. Evaluation of all matters of continuing accounting significance.
- c. Opinion of any subsequent events occurring since the predecessor's audit report was issued.
- d. Understanding as to the reasons for the change of auditors.

M88#55. When planning an examination, an auditor should

- a. Consider whether the extent of substantive tests may be reduced based on the results of the internal control questionnaire.
- b. Make preliminary judgments about materiality levels for audit purposes.
- c. Conclude whether changes in compliance with prescribed control procedures justifies reliance on them.
- d. Prepare a preliminary draft of the management representation letter.

M88#56. A difference of opinion regarding the results of a sample can not be resolved between the assistant who performed the auditing procedures and the in-charge auditor. The assistant should

- a. Refuse to perform any further work on the engagement.

- b. Accept the judgment of the more experienced in-charge auditor.
- c. Document the disagreement and ask to be disassociated from the resolution of the matter.
- d. Notify the client that a serious audit problem exists.

M88#57. A CPA firm studies its personnel advancement experience to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility. This is evidence of the firm's adherence to prescribed standards of

- a. Supervision and review.
- b. Continuing professional education.
- c. Professional development.
- d. Quality control.

N87#20. In planning a new engagement, which of the following is **not** a factor that affects the auditor's judgment as to the quantity, type, and content of working papers?

- a. The auditor's estimated occurrence rate of attributes.
- b. The auditor's preliminary evaluations of risk based on discussions with the client.
- c. The content of the client's representation letter.
- d. The type of report to be issued by the auditor.

N87#23. The risk that an auditor's procedures will lead to the conclusion that a material error does **not** exist in an account balance when, in fact, such error does exist is referred to as

- a. Audit risk.
- b. Inherent risk.
- c. Control risk.
- d. Detection risk.

N87#26. The element of the audit planning process most likely to be agreed upon with the client before implementation of the audit strategy is the determination of the

- a. Methods of statistical sampling to be used in confirming accounts receivable.
- b. Pending legal matters to be included in the inquiry of the client's attorney.
- c. Evidence to be gathered to provide a sufficient basis for the auditor's opinion.
- d. Schedules and analyses to be prepared by the client's staff.

N87#27. As lower acceptable levels of both audit risk and materiality are established, the auditor should plan more work on individual accounts to

- a. Find smaller errors.
- b. Find larger errors.
- c. Increase the tolerable error in the accounts.
- d. Decrease the risk of overreliance.

Selected Questions

N87#49. CPA firms should establish quality control policies and procedures for professional development in order to provide reasonable assurance that

- a. Employees promoted possess the appropriate characteristics to perform competently.
- b. Personnel will have the knowledge required to fulfill responsibilities assigned.
- c. The extent of supervision and review in a given instance will be appropriate.
- d. Association with a client whose management lacks integrity will be minimized.

N86#7. Which of the following factors most likely affects the auditor's judgment about the quantity, type, and content of working papers?

- a. The degree of reliance on internal accounting control.
- b. The content of the client's representation letter.
- c. The timing of substantive tests completed prior to the balance sheet date.
- d. The usefulness of the working papers as a reference source for the client.

N86#8. A written understanding between the auditor and the client concerning the auditor's responsibility for the discovery of illegal acts is usually set forth in a(an)

- a. Client representation letter.
- b. Letter of audit inquiry.
- c. Management letter.
- d. Engagement letter.

N86#9. When one auditor succeeds another, the successor auditor should request the

- a. Client to instruct its attorney to send a letter of audit inquiry concerning the status of the prior year's litigation, claims, and assessments.
- b. Predecessor auditor to submit a list of internal accounting control weaknesses that have **not** been corrected.
- c. Client to authorize the predecessor auditor to allow a review of the predecessor auditor's working papers.
- d. Predecessor auditor to update the prior year's report to the date of the change of auditors.

N86#10. Prior to beginning the field work on a new audit engagement in which a CPA does **not** possess expertise in the industry in which the client operates, the CPA should

- a. Reduce audit risk by lowering the preliminary levels of materiality.
- b. Design special substantive tests to compensate for the lack of industry expertise.
- c. Engage financial experts familiar with the nature of the industry.
- d. Obtain a knowledge of matters that relate to the nature of the entity's business.

M86#4. In connection with the element of professional development, a CPA firm's system of quality control should ordinarily provide that all personnel

- a. Have the knowledge required to enable them to fulfill responsibilities assigned.
- b. Possess judgment, motivation, and adequate experience.
- c. Seek assistance from persons having appropriate levels of knowledge, judgment, and authority.
- d. Demonstrate compliance with peer review directives.

M86#20. Before applying principal substantive tests to the details of asset and liability accounts at an interim date, the auditor should

- a. Assess the difficulty in controlling incremental audit risk.
- b. Investigate significant fluctuations that have occurred in the asset and liability accounts since the previous balance-sheet date.
- c. Select only those accounts which can effectively be sampled during year-end audit work.
- d. Consider the compliance tests that must be applied at the balance-sheet date to extend the audit conclusions reached at the interim date.

M86#26. A part of the auditor's planning of an audit engagement should be a plan to search for

- a. Errors or irregularities that would have a material or immaterial effect on the financial statements.
- b. Errors or irregularities that would have a material effect on the financial statements.
- c. Errors that would have a material effect on the financial statements, but the auditor need **not** plan to search for irregularities.
- d. Irregularities that would have a material effect on the financial statements, but the auditor need **not** plan to search for errors.

N85#3. Quality control for a CPA firm, as referred to in Statements on Quality Control Standards, applies to

- a. Auditing services only.
- b. Auditing and management advisory services.
- c. Auditing and tax services.
- d. Auditing and accounting and review services.

N85#10. A prospective client's refusal to grant a CPA permission to communicate with the predecessor auditor will bear directly on the CPA's ability to

- a. Study and evaluate the client's system of internal control.
- b. Determine the integrity of management.
- c. Determine the beginning balances of the current year's financial statements.
- d. Establish consistency in application of GAAP between years.

Auditing

M85#3. Prior to the acceptance of an audit engagement with a client who has terminated the services of the predecessor auditor, the CPA should

- a. Contact the predecessor auditor without advising the prospective client and request a complete report of the circumstance leading to the termination with the understanding that all information disclosed will be kept confidential.
- b. Accept the engagement without contacting the predecessor auditor since the CPA can include audit procedures to verify the reason given by the client for the termination.
- c. Not communicate with the predecessor auditor because this would in effect be asking the auditor to violate the confidential relationship between auditor and client.
- d. Advise the client of the intention to contact the predecessor auditor and request permission for the contact.

M85#18. A CPA firm's personnel partner periodically studies the CPA firm's personnel advancement experience to ascertain whether individuals meeting stated criteria are assigned increased degrees of responsibility. This is evidence of the CPA firm's adherence to prescribed standards of

- a. Quality control.
- b. Due professional care.
- c. Supervision and review.
- d. Fieldwork.

M85#49. Early appointment of the auditor enables preliminary work to be performed by the auditor which benefits the client in that it permits the examination to be performed in

- a. A more efficient manner.
- b. A more thorough manner.
- c. Accordance with quality control standards.
- d. Accordance with generally accepted auditing standards.

C. Other Responsibilities

N88#9. Which of the following circumstances would most likely cause an auditor to suspect that material irregularities exist in a client's financial statements?

- a. Property and equipment are usually sold at a loss before being fully depreciated.
- b. Significantly fewer responses to confirmation requests are received than expected.
- c. Monthly bank reconciliations usually include several in-transit items.
- d. Clerical errors are listed on an EDP-generated exception report.

N88#10. An auditor's tests of the pricing of a client's inventory indicates the existence of many errors. However, because of inadequate records the auditor is un-

certain about whether these errors materially affect the financial statements taken as a whole. The auditor may reasonably issue a (an)

	<u>"Subject to" qualified opinion</u>	<u>Adverse opinion</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N88#12. An auditor of a manufacturer would most likely question whether that client has committed illegal acts if the client has

- a. Been forced to discontinue operations in a foreign country.
- b. Been an annual donor to a local political candidate.
- c. Failed to correct material weaknesses in internal accounting control that were reported after the prior year's audit.
- d. Disclosed several subsequent events involving foreign operations in the notes to the financial statements.

N88#15. Which of the following standards applies to management advisory services engagements?

- a. In all matters relating to the assignment, an independence in mental attitude is to be maintained.
- b. There is to be a proper study and evaluation of the existing internal accounting control as a basis for reliance thereon.
- c. The work is to be adequately planned and assistants are to be properly supervised.
- d. Informative disclosures are to be regarded as reasonably adequate unless otherwise stated in the report.

N88#30. An accountant should **not** submit unaudited financial statements to the management of a nonpublic company unless, at a minimum, the accountant

- a. Assists in adjusting the books of account and prepares the trial balance.
- b. Types or reproduces the financial statements on plain paper.
- c. Complies with the standards applicable to compilation engagements.
- d. Applies analytical procedures to the financial statements.

M88#58. An entity's financial statements were misstated over a period of years due to large amounts of revenue being recorded in journal entries that involved

Selected Questions

debits and credits to an illogical combination of accounts. The auditor could most likely have been alerted to this irregularity by

- a. Scanning the general journal for unusual entries.
- b. Performing a revenue cut-off test at year-end.
- c. Tracing a sample of journal entries to the general ledger.
- d. Examining documentary evidence of sales returns and allowances recorded after year-end.

M88#59. The refusal of a client's attorney to provide a representation on the legality of a particular act committed by the client is generally

- a. Sufficient reason to issue a "subject to" qualified opinion.
- b. Considered to be a scope limitation.
- c. Insufficient reason to modify the auditor's report due to the attorney's obligation of confidentiality.
- d. Proper grounds to withdraw from the engagement.

M88#60. If compiled financial statements presented in conformity with the cash receipts and disbursements basis of accounting do **not** disclose the basis of accounting used, the accountant should

- a. Disclose the basis in the notes to the financial statements.
- b. Clearly label each page "Unaudited."
- c. Disclose the basis of accounting in the accountant's report.
- d. Recompile the financial statements using generally accepted accounting principles.

N87#10. When third party use of prospective financial statements is expected, an accountant may **not** accept an engagement to

- a. Perform a review.
- b. Perform a compilation.
- c. Perform an examination.
- d. Apply agreed-upon procedures.

N87#24. Because an examination in accordance with generally accepted auditing standards is influenced by the possibility of material errors, the auditor should conduct the examination with an attitude of

- a. Professional responsiveness.
- b. Conservative advocacy.
- c. Objective judgment.
- d. Professional skepticism.

N87#25. With respect to errors and irregularities, the auditor should plan to

- a. Search for errors that would have a material effect and for irregularities that would have either material or immaterial effect on the financial statements.

- b. Search for irregularities that would have a material effect and for errors that would have either material or immaterial effect on the financial statements.
- c. Search for errors or irregularities that would have a material effect on the financial statements.
- d. Discover errors or irregularities that have either material or immaterial effect on the financial statements.

N87#28. The most likely explanation why the auditor's examination **cannot** reasonably be expected to bring all illegal acts by the client to the auditor's attention is that

- a. Illegal acts are perpetrated by management override of internal accounting controls.
- b. Illegal acts by clients often relate to operating aspects rather than accounting aspects.
- c. The client's system of internal accounting control may be so strong that the auditor performs only minimal substantive testing.
- d. Illegal acts may be perpetrated by the only person in the client's organization with access to both assets and the accounting records.

N87#29. A CPA should **not** submit unaudited financial statements of a nonpublic company to a client or others unless, as a minimum, the CPA complies with the provisions applicable to

- a. Compilation engagements.
- b. Review engagements.
- c. Statements on auditing standards.
- d. Attestation standards.

M87#5. When unable to obtain sufficient competent evidential matter to determine whether certain client acts are illegal, the auditor would most likely issue

- a. An unqualified opinion with a separate explanatory paragraph.
- b. Either a qualified opinion or an adverse opinion.
- c. Either a disclaimer of opinion or a qualified opinion.
- d. Either an adverse opinion or a disclaimer of opinion.

M87#6. The primary purpose of a management advisory services engagement is to help the client

- a. Become more profitable by relying upon the CPA's existing personal knowledge about the client's business.
- b. Improve the use of its capabilities and resources to achieve its objectives.
- c. Document and quantify its future plans without impairing the CPA's objectivity or allowing the CPA to assume the role of management.
- d. Obtain benefits that are guaranteed implicitly by the CPA.

Auditing

N86#3. Under Statements on Auditing Standards, which of the following would be classified as an error?

- a. Misappropriation of assets for the benefit of management.
- b. Misinterpretation by management of facts that existed when the financial statements were prepared.
- c. Preparation of records by employees to cover a fraudulent scheme.
- d. Intentional omission of the recording of a transaction to benefit a third party.

N86

Items 14 and 15 are based on the following information:

During the annual audit of BCD Corp., a publicly held company, Smith, CPA, a continuing auditor, determined that illegal political contributions had been made during each of the past seven years, including the year under audit. Smith notified the board of directors of BCD Corp. of the illegal contributions, but they refused to take any action because the amounts involved were immaterial to the financial statements.

14. Smith should reconsider the intended degree of reliance to be placed on the

- a. Management representation letter.
- b. Preliminary judgment about materiality levels.
- c. Letter of audit inquiry to the client's attorney.
- d. Prior years' audit programs.

15. Since management took **no** action, Smith should

- a. Report the illegal contributions to the Securities and Exchange Commission.
- b. Issue an "except for" qualified opinion or an adverse opinion.
- c. Disregard the political contributions since the board of directors were notified and the amounts involved were immaterial.
- d. Consider withdrawing from the engagement or dissociating from any future relationship with BCD Corp.

N86#16. When an accountant is **not** independent of a client and is requested to perform a compilation of its financial statements, the accountant

- a. Is precluded from accepting the engagement.
- b. May accept the engagement and need **not** disclose the lack of independence.
- c. May accept the engagement and should disclose the lack of independence, but **not** the reason for the lack of independence.
- d. May accept the engagement and should disclose both the lack of independence and the reason for the lack of independence.

M86#10. When the auditor is unable to determine the amounts associated with the illegal acts of client personnel because of an inability to obtain adequate evidence, the auditor should issue a(an)

- a. "Subject to" qualified opinion.
- b. Disclaimer of opinion.
- c. Adverse opinion.
- d. Unqualified opinion with a separate explanatory paragraph.

M86#27. Which of the following control procedures may prevent the failure to bill customers for some shipments?

- a. Each shipment should be supported by a pre-numbered sales invoice that is accounted for.
- b. Each sales order should be approved by authorized personnel.
- c. Sales journal entries should be reconciled to daily sales summaries.
- d. Each sales invoice should be supported by a shipping document.

M86#28. The form of communication with a client in a management advisory service consultation should be

- a. Either oral or written.
- b. Oral with appropriate documentation in the work papers.
- c. Written and copies should be sent to both management and the board of directors.
- d. Written and a copy should be sent to management alone.

M86#37. After an auditor had been engaged to perform the first audit for a nonpublic entity, the client requested to change the engagement to a review. In which of the following situations would there be a reasonable basis to comply with the client's request?

- a. The client's bank required an audit before committing to a loan, but the client subsequently acquired alternative financing.
- b. The auditor was prohibited by the client from corresponding with the client's legal counsel.
- c. Management refused to sign the client representation letter.
- d. The auditing procedures were substantially complete and the auditor determined that an unqualified opinion was warranted, but there was a disagreement concerning the audit fee.

N85#5. If an auditor detects an illegal act that does **not** have a material effect on the client's financial statements, the auditor should generally

- a. Require that the circumstances be disclosed in the notes to the financial statements.
- b. Require the illegal act be reported to the proper legal authorities.
- c. Report on the illegal act in a separate paragraph of the auditor's report.
- d. Report the circumstances to a high-level officer within the client's firm.

Selected Questions

N85#6. A management advisory service engagement, as opposed to a management advisory service consultation, generally involves advice or information given by a CPA that is based upon

- a. An analytical approach and process.
- b. Existing personal knowledge about the client.
- c. An incidental effort devoted to a combination of activities.
- d. The CPA's ability to implement management's recommendations.

N85#8. In general, material irregularities perpetrated by which of the following are **most** difficult to detect?

- a. Internal auditor.
- b. Key-punch operator.
- c. Cashier.
- d. Controller.

N85#12. The technical standards that apply to MAS engagements require the MAS practitioner to do all of the following **except**

- a. Maintain independence from the client.
- b. Give support for and clearly identify as estimates any quantifiable results that are based on estimates.
- c. Obtain an understanding concerning the nature, scope, and limitations of the MAS engagement to be performed.
- d. Take no position which might impair the practitioner's objectivity.

M85#2. When management refuses to disclose illegal activities which were identified by the independent auditor, the independent auditor may be charged with violating the AICPA Code of Professional Ethics for

- a. Issuing a disclaimer of opinion.
- b. Withdrawing from the engagement.

- c. Failure to uncover the illegal activities during prior audits.
- d. Reporting these activities to the audit committee.

M85#19. An auditor who believes that a material irregularity may exist should initially

- a. Discuss the matter with those believed to be involved in the perpetration of the material irregularity.
- b. Discuss the matter with a higher level of management.
- c. Withdraw from the engagement.
- d. Consult legal counsel.

M85#20. A CPA should **not** undertake a management advisory service engagement that includes continued participation through implementation, unless

- a. Upon implementation a new study and evaluation of the system of internal control is performed.
- b. Upon implementation the client's personnel will have the knowledge and ability to adequately maintain and operate such systems as may be involved.
- c. The CPA accepts overall responsibility for implementation of the chosen course of action.
- d. The CPA acquires an overall knowledge of the client's business that is equivalent to that possessed by management.

M85#59. In performing MAS engagements, CPAs should **not** take any positions that might

- a. Constitute advice and assistance.
- b. Provide technical assistance in implementation.
- c. Result in new organizational policies and procedures.
- d. Impair their objectivity.

Auditing

II. Internal Control

A. Definitions and Basic Concepts

M89#6. The development of constructive suggestions to a client for improvements in its internal control structure is

- a. Addressed by the auditor only during a special engagement.
- b. As important as establishing a basis for reliance on the internal control structure.
- c. A requirement of the auditor's consideration of the internal control structure.
- d. A desirable by-product of an audit engagement.

M89#7. Which of the following statements best describes how a detailed audit program of a CPA who is engaged to audit the financial statements of a large publicly held company compares with the audit client's comprehensive internal audit program?

- a. The comprehensive internal audit program is substantially identical to the audit program used by the CPA because both cover substantially identical areas.
- b. The comprehensive internal audit program is less detailed and covers fewer areas than would normally be covered by the CPA.
- c. The comprehensive internal audit program is more detailed and covers areas that would normally not be covered by the CPA.
- d. The comprehensive internal audit program is more detailed although it covers fewer areas than would normally be covered by the CPA.

N88#31. In evaluating internal accounting control, the auditor is basically concerned that the system provides reasonable assurance that

- a. Operational efficiency has been achieved in accordance with management plans.
- b. Errors and irregularities have been prevented or detected.
- c. Controls have **not** been circumvented by collusion.
- d. Management can **not** override the system.

N88#32. Proper segregation of functional responsibilities in an effective system of internal accounting control calls for separation of the functions of

- a. Authorization, execution, and payment.
- b. Authorization, recording, and custody.
- c. Custody, execution, and reporting.
- d. Authorization, payment, and recording.

N88#36. Which of the following characteristics distinguishes computer processing from manual processing?

- a. Computer processing virtually eliminates the occurrence of computational error normally associated with manual processing.

- b. Errors or irregularities in computer processing will be detected soon after their occurrences.
- c. The potential for systematic error is ordinarily greater in manual processing than in computerized processing.
- d. Most computer systems are designed so that transaction trails useful for audit purposes do **not** exist.

M88#2. When considering the objectivity of internal auditors, an independent auditor should

- a. Evaluate the quality control program in effect for the internal auditors.
- b. Examine documentary evidence of the work performed by the internal auditors.
- c. Test a sample of the transactions and balances that the internal auditors examined.
- d. Determine the organizational level to which the internal auditors report.

N87#42. The use of fidelity bonds may indemnify a company from embezzlement losses. The use also

- a. Reduces the company's need to obtain expensive business interruption insurance.
- b. Protects employees who made unintentional errors from possible monetary damages resulting from such errors.
- c. Allows the company to substitute the fidelity bonds for various parts of internal accounting control.
- d. Reduces the possibility of employing persons with dubious records in positions of trust.

M87#2. When considering internal control, an auditor should be aware of the concept of reasonable assurance, which recognizes that the

- a. Segregation of incompatible functions is necessary to ascertain that internal control is effective.
- b. Employment of competent personnel provides assurance that the objectives of internal control will be achieved.
- c. Establishment and maintenance of a system of internal control is an important responsibility of the management and **not** of the auditor.
- d. Cost of internal control should **not** exceed the benefits expected to be derived from internal control.

N86#13. A secondary objective of the auditor's study and evaluation of internal accounting control is that the study and evaluation provide

- a. A basis for determining the nature, extent, and timing of audit tests.
- b. Assurance that management's procedures to detect irregularities are properly functioning.

Selected Questions

- c. A basis for constructive suggestions concerning improvements in internal accounting control.
- d. Evidence that incompatible functions for accounting control purposes have been eliminated.

N86#18. Which of the following is a provision of the Foreign Corrupt Practices Act?

- a. It is a criminal offense for an auditor to fail to detect and report a bribe paid by an American business entity to a foreign official for the purpose of obtaining business.
- b. The auditor's detection of illegal acts committed by officials of the auditor's publicly held client in conjunction with foreign officials should be reported to the Enforcement Division of the Securities and Exchange Commission.
- c. If the auditor of a publicly held company concludes that the effects on the financial statements of a bribe given to a foreign official are **not** susceptible of reasonable estimation, the auditor's report should be modified.
- d. Every publicly held company must devise, document, and maintain a system of internal accounting controls sufficient to provide reasonable assurances that internal accounting control objectives are met.

M86#12. Where computer processing is used in significant accounting applications, internal accounting control procedures may be defined by classifying control procedures into two types: general and

- a. Administrative.
- b. Specific.
- c. Application.
- d. Authorization.

M86#31. Of the following statements about an internal accounting control system, which one is correct?

- a. The maintenance of the system of internal accounting control is an important responsibility of the internal auditor.
- b. Administrative controls relate directly to the safeguarding of assets and the systems of authorization and approval.
- c. Because of the cost/benefit relationship, internal accounting control procedures may be applied on a test basis in some circumstances.
- d. Internal accounting control procedures reasonably ensure that collusion among employees can **not** occur.

N85#37. If the independent auditors decide that the work performed by the internal auditor may have a

bearing on their own procedures, they should consider the internal auditor's

- a. Competence and objectivity.
- b. Efficiency and experience.
- c. Independence and review skills.
- d. Training and supervisory skills.

M85#5. In general, a material internal accounting control weakness may be defined as a condition in which material errors or irregularities may occur and **not** be detected within a timely period by

- a. An independent auditor during the compliance test phase of the study and evaluation of internal accounting control procedures.
- b. Employees in the normal course of performing their assigned functions.
- c. Management when reviewing interim financial statements and reconciling account balances.
- d. Outside consultants who issue a special-purpose report on internal control.

M85#7. Internal accounting controls are **not** designed to provide reasonable assurance that

- a. Transactions are executed in accordance with management's authorization.
- b. Irregularities will be eliminated.
- c. Access to assets is permitted only in accordance with management's authorization.
- d. The recorded accountability for assets is compared with the existing assets at reasonable intervals.

M85#22. To provide for the greatest degree of independence in performing internal auditing functions, an internal auditor most likely should report to the

- a. Financial vice-president.
- b. Corporate controller.
- c. Board of directors.
- d. Corporate stockholders.

M85#25. Which of the following activities would most likely be performed in the EDP department?

- a. Initiation of changes to master records.
- b. Conversion of information to machine-readable form.
- c. Correction of transactional errors.
- d. Initiation of changes to existing applications.

M85#26. For control purposes, which of the following should be organizationally segregated from the computer operations function?

- a. Data conversion.
- b. Surveillance of CRT messages.
- c. Systems development.
- d. Minor maintenance according to a schedule.

Auditing

B. Consideration of the Internal Control Structure

M89#8. As a result of tests of controls, an auditor overrelied on internal control and decreased substantive testing. This overreliance occurred because the true deviation rate in the population was

- a. Less than the risk of overreliance on the auditor's sample.
- b. Less than the deviation rate in the auditor's sample.
- c. More than the risk of overreliance on the auditor's sample.
- d. More than the deviation rate in the auditor's sample.

M89#9. A procedure that would most likely be used by an auditor in performing tests of control procedures that involve segregation of functions and that leave no transaction trail is

- a. Inspection.
- b. Observation.
- c. Reperformance.
- d. Reconciliation.

M89#10. Which of the following is **not** a reason an auditor should obtain an understanding of the elements of an entity's internal control structure in planning an audit?

- a. Identify the types of potential misstatements that can occur.
- b. Design substantive tests.
- c. Consider the operating effectiveness of the internal control structure.
- d. Consider factors that affect the risk of material misstatements.

M89#11. Which of the following is **not** an element of an entity's internal control structure?

- a. Control risk.
- b. Control procedures.
- c. The accounting system.
- d. The control environment.

M89#12. Errors in data processed in a batch computer system may **not** be detected immediately because

- a. Transaction trails in a batch system are available only for a limited period of time.
- b. There are time delays in processing transactions in a batch system.
- c. Errors in some transactions cause rejection of other transactions in the batch.
- d. Random errors are more likely in a batch system than in an on-line system.

M89#13. When EDP programs or files can be accessed from terminals, users should be required to enter a(an)

- a. Parity check.
- b. Personal identification code.
- c. Self-diagnosis test.
- d. Echo check.

N88#34. When performing the review of an internal accounting control system's design, an auditor may obtain answers to an internal accounting control questionnaire. The next step ordinarily should be to

- a. Make a preliminary evaluation of whether specific control procedures are suitably designed for reliance, assuming satisfactory compliance.
- b. Perform compliance tests to provide reasonable assurance that the control procedures are being applied as prescribed.
- c. Gather enough evidence to determine if the internal accounting control system is effective in preventing or detecting errors and irregularities.
- d. Design substantive tests that do **not** contemplate reliance on the control procedures that appear to be ineffective.

N88#38. Which of the following would most likely be a weakness in the internal accounting control system of a client that utilizes microcomputers rather than a larger computer system?

- a. Employee collusion possibilities are increased because microcomputers from one vendor can process the programs of a system from a different vendor.
- b. The microcomputer operators may be able to remove hardware and software components and modify them at home.
- c. Programming errors result in all similar transactions being processed incorrectly when those transactions are processed under the same conditions.
- d. Certain transactions may be automatically initiated by the microcomputers and management's authorization of these transactions may be implicit in its acceptance of the system design.

N88#39. During the review of a small business client's internal accounting control system, the auditor discovered that the accounts receivable clerk approves credit memos and has access to cash. Which of the following controls would be most effective in offsetting this weakness?

- a. The owner reviews errors in billings to customers and postings to the subsidiary ledger.
- b. The controller receives the monthly bank statement directly and reconciles the checking accounts.
- c. The owner reviews credit memos after they are recorded.
- d. The controller reconciles the total of the detail accounts receivable accounts to the amount shown in the ledger.

Selected Questions

N88#49. Which of the following conclusions could an auditor most likely make on completing the preliminary phase of the review of internal accounting control?

- a. Specific control procedures are suitably designed for the auditor to rely on to restrict the extent of substantive tests, assuming satisfactory compliance.
- b. The audit effort required to study and evaluate the design of the system exceeds the reduction in audit effort that could be achieved by reliance on the system.
- c. The accounting control procedures are suitably designed to provide reasonable assurance that errors and irregularities will be prevented or detected, provided functions are properly segregated.
- d. Compliance tests indicate that access to computer operations is so unrestricted that the internal accounting control system can **not** be relied on to restrict the extent of substantive tests.

M88#3. Which of the following statements is **not** true of the test data approach when testing a computerized accounting system?

- a. The test data need consist of only those valid and invalid conditions which interest the auditor.
- b. Only one transaction of each type need be tested.
- c. The test data must consist of all possible valid and invalid conditions.
- d. Test data are processed by the client's computer programs under the auditor's control.

M88#6. An auditor performs a test to determine whether all merchandise for which the client was billed was received. The population for this test consists of all

- a. Merchandise received.
- b. Vendors' invoices.
- c. Canceled checks.
- d. Receiving reports.

M88#7. Internal accounting control is ineffective when computer department personnel

- a. Participate in computer software acquisition decisions.
- b. Design documentation for computerized systems.
- c. Originate changes in master files.
- d. Provide physical security for program files.

M88#8. An auditor may compensate for a weakness in the internal accounting control system by increasing the

- a. Level of detection risk.
- b. Extent of compliance testing.
- c. Preliminary judgment about audit risk.
- d. Extent of analytical review procedures.

N87#39. While substantive tests may support the accuracy of underlying records, these tests frequently provide **no** affirmative evidence of segregation of duties because

- a. Substantive tests rarely guarantee the accuracy of the records if only a sample of the transactions has been tested.
- b. The records may be accurate even though they are maintained by persons having incompatible functions.
- c. Substantive tests relate to the entire period under audit, but compliance tests ordinarily are confined to the period during which the auditor is on the client's premises.
- d. Many computerized procedures leave **no** audit trail of who performed them, so substantive tests may necessarily be limited to inquiries and observation of office personnel.

M87#7. Which of the following is **least** likely to be evidence the auditor examines to determine whether operations are in compliance with the internal accounting control system?

- a. Records documenting usage of EDP programs.
- b. Canceled supporting documents.
- c. Confirmations of accounts receivable.
- d. Signatures on authorization forms.

M87#8. Which of the following most likely constitutes a weakness in the internal accounting control of an EDP system?

- a. The control clerk establishes control over data received by the EDP department and reconciles control totals after processing.
- b. The application programmer identifies programs required by the systems design and flowcharts the logic of these programs.
- c. The systems analyst reviews output and controls the distribution of output from the EDP department.
- d. The accounts payable clerk prepares data for computer processing and enters the data into the computer.

M87#11. Based on a study and evaluation completed at an interim date, the auditor concludes that no significant internal accounting control weaknesses exist. The records and procedures would most likely be tested again at year-end if

- a. Compliance tests were **not** performed by the internal auditor during the remaining period.
- b. The internal accounting control system provides a basis for reliance in reducing the extent of substantive testing.
- c. The auditor used nonstatistical sampling during the interim period compliance testing.
- d. Inquiries and observations lead the auditor to believe that conditions have changed.

Auditing

M86#13. An auditor plans to examine a sample of 20 purchase orders for proper approvals as prescribed by the client's internal accounting control procedures. One of the purchase orders in the chosen sample of 20 cannot be found, and the auditor is unable to use alternative procedures to test whether that purchase order was properly approved. The auditor should

- a. Choose another purchase order to replace the missing purchase order in the sample.
- b. Consider this compliance test invalid and proceed with substantive tests since internal accounting control can **not** be relied upon.
- c. Treat the missing purchase order as a deviation for the purpose of evaluating the sample.
- d. Select a completely new set of 20 purchase orders.

M86#14. One of the major problems in an EDP system is that incompatible functions may be performed by the same individual. One compensating control for this is the use of

- a. A self-checking digit system.
- b. Echo checks.
- c. A computer log.
- d. Computer generated hash totals.

M86#25. In a study and evaluation of the system of internal accounting control, the completion of a questionnaire is most closely associated with which of the following?

- a. Tests of compliance.
- b. Substantive tests.
- c. Preliminary evaluation of the system.
- d. Review of the system design.

M86#30. Which of the following statistical sampling methods is most useful to auditors when testing for compliance?

- a. Ratio estimation.
- b. Variable sampling.
- c. Difference estimation.
- d. Discovery sampling.

M85#30. Which of the following would be **least** likely to suggest to an auditor that the client's management may have overridden the internal control system?

- a. There are numerous delays in preparing timely internal financial reports.
- b. Management does **not** correct internal control weaknesses that it knows about.
- c. Differences are always disclosed on a computer exception report.
- d. There have been two new controllers this year.

M85#51. A client erroneously recorded a large purchase twice. Which of the following internal accounting

control measures would be most likely to detect this error in a timely and efficient manner?

- a. Footing the purchases journal.
- b. Reconciling vendors' monthly statements with subsidiary payable ledger accounts.
- c. Tracing totals from the purchases journal to the ledger accounts.
- d. Sending written quarterly confirmations to all vendors.

M85#52. To determine whether the system of internal accounting control operated effectively to minimize errors of failure to invoice a shipment, the auditor would select a sample of transactions from the population represented by the

- a. Customer order file.
- b. Bill of lading file.
- c. Subsidiary customer accounts ledger.
- d. Sales invoice file.

C. Cycles

M89#14. When goods are received, the receiving clerk should match the goods with the

- a. Purchase order and the requisition form.
- b. Vendor's invoice and the receiving report.
- c. Vendor's shipping document and the purchase order.
- d. Receiving report and the vendor's shipping document.

M89#15. The mailing of disbursement checks and remittance advices should be controlled by the employee who

- a. Signed the checks last.
- b. Approved the vouchers for payment.
- c. Matched the receiving reports, purchase orders, and vendors' invoices.
- d. Verified the mathematical accuracy of the vouchers and remittance advices.

M89#16. An auditor who is testing EDP controls in a payroll system would most likely use test data that contain conditions such as

- a. Deductions **not** authorized by employees.
- b. Overtime **not** approved by supervisors.
- c. Time tickets with invalid job numbers.
- d. Payroll checks with unauthorized signatures.

M89#17. The purpose of segregating the duties of hiring personnel and distributing payroll checks is to separate the

- a. Administrative controls from the internal accounting controls.
- b. Human resources function from the controllership function.
- c. Operational responsibility from the record keeping responsibility.
- d. Authorization of transactions from the custody of related assets.

Selected Questions

M89#18. Independent internal verification of inventory occurs when employees who

- a. Issue raw materials obtain material requisitions for each issue and prepare daily totals of materials issued.
- b. Compare records of goods on hand with physical quantities do **not** maintain the records or have custody of the inventory.
- c. Obtain receipts for the transfer of completed work to finished goods prepare a completed production report.
- d. Are independent of issuing production orders update records from completed job cost sheets and production cost reports on a timely basis.

M89#19. When there are numerous property and equipment transactions during the year, an auditor planning to assess control risk at the minimum level usually plans to obtain an understanding of the internal control structure and to perform

- a. Tests of controls and extensive tests of property and equipment balances at the end of the year.
- b. Extensive tests of current year property and equipment transactions.
- c. Tests of controls and limited tests of current year property and equipment transactions.
- d. Analytical procedures for property and equipment balances at the end of the year.

N88#40. At which point in an ordinary sales transaction of a wholesaling business would a lack of specific authorization **least** concern the auditor conducting an audit?

- a. Determining discounts.
- b. Selling goods for cash.
- c. Granting credit.
- d. Shipping goods.

N88#41. Cash receipts from sales on account have been misappropriated. Which of the following acts would conceal this defalcation and be **least** likely to be detected by an auditor?

- a. Understating the sales journal.
- b. Overstating the accounts receivable control account.
- c. Overstating the accounts receivable subsidiary ledger.
- d. Understating the cash receipts journal.

N88#42. For effective internal accounting control, the accounts payable department should compare the information on each vendor's invoice with the

- a. Receiving report and the purchase order.
- b. Receiving report and the voucher.
- c. Vendor's packing slip and the purchase order.
- d. Vendor's packing slip and the voucher.

N88#43. Which of the following is the most effective control procedure to detect vouchers that were prepared for the payment of goods that were **not** received?

- a. Count goods upon receipt in storeroom.
- b. Match purchase order, receiving report, and vendor's invoice for each voucher in accounts payable department.
- c. Compare goods received with goods requisitioned in receiving department.
- d. Verify vouchers for accuracy and approval in internal audit department.

N88#44. Which of the following control procedures would most likely be used to maintain accurate perpetual inventory records?

- a. Independent storeroom count of goods received.
- b. Periodic independent reconciliation of control and subsidiary records.
- c. Periodic independent comparison of records with goods on hand.
- d. Independent matching of purchase orders, receiving reports, and vendors' invoices.

N88#45. If a control total were to be computed on each of the following data items, which would best be identified as a hash total for a payroll EDP application?

- a. Hours worked.
- b. Total debits and total credits.
- c. Net pay.
- d. Department numbers.

N88#46. Which of the following procedures is most likely to prevent the improper disposition of equipment?

- a. A separation of duties between those authorized to dispose of equipment and those authorized to approve removal work orders.
- b. The use of serial numbers to identify equipment that could be sold.
- c. Periodic comparison of removal work orders to authorizing documentation.
- d. A periodic analysis of the scrap sales and the repairs and maintenance accounts.

M88#5. The objectives of internal accounting control for a production cycle are to provide assurance that transactions are properly executed and recorded, and that

- a. Custody of work in process and of finished goods is properly maintained.
- b. Production orders are prenumbered and signed by a supervisor.
- c. Raw materials purchases are authorized by the purchasing department.
- d. Independent internal verification of activity reports is established.

Auditing

M88#9. Internal accounting control is strengthened when the quantity of merchandise ordered is omitted from the copy of the purchase order sent to the

- a. Department that initiated the requisition.
- b. Receiving department.
- c. Purchasing agent.
- d. Accounts payable department.

M88#10. Property acquisitions that are misclassified as maintenance expense would most likely be detected by an internal accounting control system that provides for

- a. Investigation of variances within a formal budgeting system.
- b. Review and approval of the monthly depreciation entry by the plant supervisor.
- c. Segregation of duties of employees in the accounts payable department.
- d. Examination by the internal auditor of vendor invoices and canceled checks for property acquisitions.

M88#11. Sound internal accounting control procedures dictate that defective merchandise returned by customers should be presented to the

- a. Inventory control clerk.
- b. Sales clerk.
- c. Purchasing clerk.
- d. Receiving clerk.

M88#13. An effective system of internal accounting control over the payroll function would include

- a. Verification of agreement of job time tickets with employee clock card hours by a payroll department employee.
- b. Reconciliation of totals on job time tickets with job reports by employees responsible for those specific jobs.
- c. Custody of rate authorization records by the supervisor of the payroll department.
- d. Preparation of payroll transaction journal entries by an employee who reports to the supervisor of the personnel department.

M88#20. Which of the following procedures in the cash disbursements cycle should **not** be performed by the accounts payable department?

- a. Comparing the vendor's invoice with the receiving report.
- b. Canceling supporting documentation after payment.
- c. Verifying the mathematical accuracy of the vendor's invoice.
- d. Signing the voucher for payment by an authorized person.

N87#47. The most likely result of ineffective internal accounting controls in the revenue cycle is that

- a. Fictitious transactions could be recorded, causing an understatement of revenues and overstatement of receivables.

- b. Irregularities in recording transactions in the subsidiary accounts could result in a delay in goods shipped.
- c. Omission of shipping documents could go undetected, causing an understatement of inventory.
- d. Final authorization of credit memos by personnel in the sales department could permit an employee defalcation scheme.

N87#48. An auditor generally tests physical security controls over inventory by

- a. Test counts and cutoff procedures.
- b. Examination and reconciliation.
- c. Inspection and recomputation.
- d. Inquiry and observation.

N87#50. Which of the following internal accounting control procedures would most likely allow for a reduction in the scope of the auditor's tests of depreciation expense?

- a. Review and approval of the periodic equipment depreciation entry by a supervisor who does **not** actively participate in its preparation.
- b. Comparison of equipment account balances for the current year with the current-year budget and prior-year actual balances.
- c. Review of the miscellaneous income account for salvage credits and scrap sales of partially depreciated equipment.
- d. Authorization of payment of vendors' invoices by a designated employee who is independent of the equipment receiving function.

N87#53. For the most effective internal accounting control, monthly bank statements should be received directly from the banks and reviewed by the

- a. Controller.
- b. Cash receipts accountant.
- c. Cash disbursements accountant.
- d. Internal auditor.

N87#54. An auditor would consider internal accounting control over a client's payroll procedures to be ineffective if the payroll department supervisor is responsible for

- a. Hiring subordinate payroll department employees.
- b. Having custody over unclaimed paychecks.
- c. Updating employee earnings records.
- d. Applying pay rates to time tickets.

N87#55. Which of the following departments should have the responsibility for authorizing payroll rate changes?

- a. Personnel.
- b. Payroll.
- c. Treasurer.
- d. Timekeeping.

Selected Questions

M87#56. An auditor selects a sample from the file of shipping documents to determine whether invoices were prepared. This test is performed to satisfy the audit objective of

- a. Accuracy.
- b. Completeness.
- c. Control.
- d. Existence.

M87#12. For effective internal accounting control, employees maintaining the accounts receivable subsidiary ledger should **not** also approve

- a. Employee overtime wages.
- b. Credit granted to customers.
- c. Write-offs of customer accounts.
- d. Cash disbursements.

M87#13. The completeness of EDP-generated sales figures can be tested by comparing the number of items listed on the daily sales report with the number of items billed on the actual invoices. This process uses

- a. Check digits.
- b. Control totals.
- c. Validity tests.
- d. Process tracing data.

M87#14. An internal accounting control questionnaire indicates that an approved receiving report is required to accompany every check request for payment of merchandise. Which of the following procedures provides the greatest assurance that this control is operating effectively?

- a. Select and examine cancelled checks and ascertain that the related receiving reports are dated **no** earlier than the checks.
- b. Select and examine cancelled checks and ascertain that the related receiving reports are dated **no** later than the checks.
- c. Select and examine receiving reports and ascertain that the related cancelled checks are dated **no** earlier than the receiving reports.
- d. Select and examine receiving reports and ascertain that the related cancelled checks are dated **no** later than the receiving reports.

M87#15. In a properly designed internal accounting control system, the same employee may be permitted to

- a. Receive and deposit checks, and also approve write-offs of customer accounts.
- b. Approve vouchers for payment, and also sign checks.
- c. Reconcile the bank statements, and also receive and deposit cash.
- d. Sign checks, and also cancel supporting documents.

M87#16. Instead of taking a physical inventory count on the balance-sheet date the client may take physical

counts prior to the year-end if internal accounting controls are adequate and

- a. Computerized records of perpetual inventory are maintained.
- b. Inventory is slow-moving.
- c. EDP error reports are generated for missing prenumbered inventory tickets.
- d. Obsolete inventory items are segregated and excluded.

M87#17. Which of the following internal accounting control procedures could best prevent direct labor from being charged to manufacturing overhead?

- a. Reconciliation of work in process inventory with cost records.
- b. Comparison of daily journal entries with factory labor summary.
- c. Comparison of periodic cost budgets and time cards.
- d. Reconciliation of unfinished job summary and production cost records.

M87#20. The auditor may observe the distribution of paychecks to ascertain whether

- a. Payrate authorization is properly separated from the operating function.
- b. Deductions from gross pay are calculated correctly and are properly authorized.
- c. Employees of record actually exist and are employed by the client.
- d. Paychecks agree with the payroll register and the time cards.

M87#21. A weakness in internal accounting control over recording retirements of equipment may cause the auditor to

- a. Inspect certain items of equipment in the plant and trace those items to the accounting records.
- b. Review the subsidiary ledger to ascertain whether depreciation was taken on each item of equipment during the year.
- c. Trace additions to the "other assets" account to search for equipment that is still on hand but **no** longer being used.
- d. Select certain items of equipment from the accounting records and locate them in the plant.

N86#22. To determine whether the system of internal accounting control operated effectively to minimize errors of failure to invoice a shipment, the auditor would select a sample of transactions from the population represented by the

- a. Customer order file.
- b. Bill of lading file.
- c. Open invoice file.
- d. Sales invoice file.

Auditing

N86#23. For the accounting system of Acme Company the amounts of cash disbursements entered into an EDP terminal are transmitted to the computer that immediately transmits the amounts back to the terminal for display on the terminal screen. This display enables the operator to

- a. Establish the validity of the account number.
- b. Verify the amount was entered accurately.
- c. Verify the authorization of the disbursement.
- d. Prevent the overpayment of the account.

N86#24. Which of the following is a question that the auditor would expect to find on the production cycle section of an internal accounting control questionnaire?

- a. Are vendors' invoices for raw materials approved for payment by an employee who is independent of the cash disbursements function?
- b. Are signed checks for the purchase of raw materials mailed directly after signing without being returned to the person who authorized the invoice processing?
- c. Are all releases by storekeepers of raw materials from storage based on approved requisition documents?
- d. Are details of individual disbursements for raw materials balanced with the total to be posted to the appropriate general ledger account?

M86#1. Matthews Corp. has changed from a system of recording time worked on clock cards to a computerized payroll system in which employees record time in and out with magnetic cards. The EDP system automatically updates all payroll records. Because of this change

- a. A generalized computer audit program must be used.
- b. Part of the audit trail is altered.
- c. The potential for payroll related fraud is diminished.
- d. Transactions must be processed in batches.

M86#38. Alpha Company uses its sales invoices for posting perpetual inventory records. Inadequate internal accounting controls over the invoicing function allow goods to be shipped that are not invoiced. The inadequate controls could cause an

- a. Understatement of revenues, receivables, and inventory.
- b. Overstatement of revenues and receivables, and an understatement of inventory.
- c. Understatement of revenues and receivables, and an overstatement of inventory.
- d. Overstatement of revenues, receivables, and inventory.

M86#39. In a properly designed accounts payable system, a voucher is prepared after the invoice, purchase

order, requisition, and receiving report are verified. The next step in the system is to

- a. Cancel the supporting documents.
- b. Enter the check amount in the check register.
- c. Approve the voucher for payment.
- d. Post the voucher amount to the expense ledger.

M86#45. To achieve good internal accounting control which department should perform the activities of matching shipping documents with sales orders and preparing daily sales summaries?

- a. Billing.
- b. Shipping.
- c. Credit.
- d. Sales order.

M86#58. A small client recently put its cash disbursements system on a microcomputer. About which of the following internal accounting control features would an auditor most likely be concerned?

- a. Programming of this microcomputer is in BASIC, although COBOL is the dominant, standard language for business processing.
- b. This microcomputer is operated by employees who have other, non-data-processing job responsibilities.
- c. The microcomputer terminal is physically close to the computer and directly connected to it.
- d. There are restrictions on the amount of data that can be stored and on the length of time that data can be stored.

N85#19. Tracing bills of lading to sales invoices will provide evidence that

- a. Recorded sales were shipped.
- b. Invoiced sales were shipped.
- c. Shipments to customers were invoiced.
- d. Shipments to customers were recorded as sales.

N85#20. Which of the following accounts would most likely be reviewed by the auditor to gain reasonable assurance that additions to the equipment account are not understated?

- a. Repairs and maintenance expense.
- b. Depreciation expense.
- c. Gain on disposal of equipment.
- d. Accounts payable.

N85#27. The purpose of segregating the duties of distributing payroll checks and hiring personnel is to separate the

- a. Duties within the accounting function.
- b. Custody of assets from the accounting for those assets.
- c. Authorization of transactions from the custody of related assets.
- d. Operational responsibility from record keeping responsibility.

Selected Questions

N85#28. If the perpetual inventory records show lower quantities of inventory than the physical count, an explanation of the difference might be unrecorded

- a. Sales.
- b. Sales discounts.
- c. Purchases.
- d. Purchase discounts.

N85#34. When counting cash on hand the auditor must exercise control over all cash and other negotiable assets to prevent

- a. Theft.
- b. Irregular endorsement.
- c. Substitution.
- d. Deposits-in-transit.

M85#9. Which one of the following would the auditor consider to be an incompatible operation if the cashier receives remittances from the mailroom?

- a. The cashier posts the receipts to the accounts receivable subsidiary ledger cards.
- b. The cashier makes the daily deposit at a local bank.
- c. The cashier prepares the daily deposit.
- d. The cashier endorses the checks.

M85#24. Which of the following is an example of a check digit?

- a. An agreement of the total number of employees to the total number of checks printed by the computer.
- b. An algebraically determined number produced by the other digits of the employee number.
- c. A logic test that ensures all employee numbers are nine digits.
- d. A limit check that an employee's hours do not exceed 50 hours per work week.

M85#38. The accounts payable department receives the purchase order form to accomplish all of the following **except**

- a. Compare invoice price to purchase order price.
- b. Ensure the purchase had been properly authorized.
- c. Ensure the goods had been received by the party requesting the goods.
- d. Compare quantity ordered to quantity purchased.

M85#40. Which of the following internal accounting control procedures could best prevent direct labor from being charged to manufacturing overhead?

- a. Comparison of daily journal entries with factory labor summary.
- b. Examination of routing tickets from finished goods on delivery.

- c. Reconciliation of work in process inventory with cost records.
- d. Recomputation of direct labor based on inspection of time cards.

M85#53. To strengthen internal accounting control over the custody of heavy mobile equipment, the client would most likely institute a policy requiring a periodic

- a. Increase in insurance coverage.
- b. Inspection of equipment and reconciliation with accounting records.
- c. Verification of liens, pledges, and collateralizations.
- d. Accounting for work orders.

M85#60. For an appropriate segregation of duties, journalizing and posting summary payroll transactions should be assigned to

- a. The treasurer's department.
- b. General accounting.
- c. Payroll accounting.
- d. The timekeeping department.

D. Other Considerations

M89#20. Which of the following statements is correct concerning an auditor's communication of internal control structure related matters (reportable conditions) noted in an audit?

- a. The auditor may issue a written report to the audit committee representing that **no** reportable conditions were noted during the audit.
- b. Reportable conditions should be recommunicated each year even if the audit committee has acknowledged its understanding of such deficiencies.
- c. Reportable conditions may **not** be communicated in a document that contains suggestions regarding activities that concern other topics such as business strategies or administrative efficiencies.
- d. The auditor may choose to communicate significant internal control structure related matters either during the course of the audit or after the audit is concluded.

M89#21. An accountant's report expressing an opinion on an entity's internal controls should contain a

- a. Statement that the entity's internal controls are consistent with that of the prior year after giving effect to subsequent changes.
- b. Brief explanation of the broad objectives and inherent limitations of internal control.
- c. Description of the principal controls that protect assets against loss from unauthorized use or disposition.
- d. Statement that the engagement was conducted in accordance with generally accepted auditing standards.

Auditing

M89#22. An independent accountant, without auditing an entity's financial statements, may accept an engagement to express an opinion on the entity's internal controls in effect

	<u>As of a specified date</u>	<u>During a specified period of time</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

M89#23. An auditor who uses statistical sampling for attributes in testing internal controls should reduce the planned reliance on a prescribed control when the

- a. Sample rate of deviation is less than the expected rate of deviation used in planning the sample.
- b. Tolerable rate less the allowance for sampling risk exceeds the sample rate of deviation.
- c. Sample rate of deviation plus the allowance for sampling risk exceeds the tolerable rate.
- d. Sample rate of deviation plus the allowance for sampling risk equals the tolerable rate.

M89#24. Which of the following factors is generally **not** considered in determining the sample size for a test of controls?

- a. Population size.
- b. Tolerable rate.
- c. Risk of overreliance.
- d. Expected population deviation rate.

M89#25. An advantage of using statistical over non-statistical sampling methods in tests of controls is that the statistical methods

- a. Afford greater assurance than a nonstatistical sample of equal size.
- b. Provide an objective basis for quantitatively evaluating sample risks.
- c. Can more easily convert the sample into a dual-purpose test useful for substantive testing.
- d. Eliminate the need to use judgment in determining appropriate sample sizes.

N88#35. An auditor's study and evaluation of the internal accounting control system made in connection

with an annual audit is usually **not** sufficient to express an opinion on an entity's system because

- a. The evaluation of weaknesses is subjective enough that an auditor should **not** express an opinion on the internal accounting controls alone.
- b. The audit cost-benefit relationship permits an auditor to express only reasonable assurance that the system operates as designed.
- c. Management may change the internal accounting controls to correct weaknesses.
- d. Only those controls on which an auditor intends to rely are reviewed, tested, and evaluated.

N88#47. Which of the following statements is correct concerning the auditor's required communication of a material weakness in internal accounting control?

- a. A weakness that management refuses to correct should be included in a separate paragraph of the auditor's report.
- b. A weakness previously communicated during the prior year's audit that has **not** been corrected should be communicated again in writing.
- c. Suggested corrective action for management's consideration concerning a weakness need **not** be communicated to the client.
- d. The auditor should test for compliance any weakness discovered before communicating it to the client.

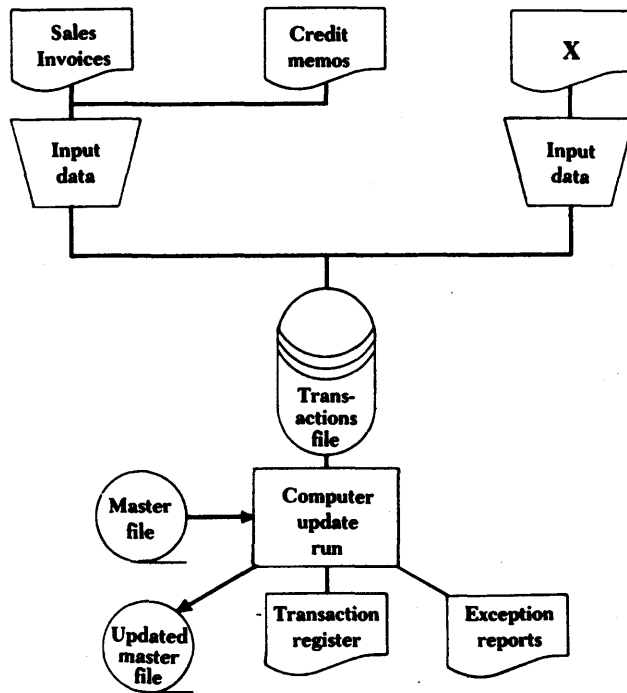
N88#48. A CPA has performed an examination of the general purpose financial statements of Big City. The examination scope included the additional requirements of the Single Audit Act. When reporting on Big City's internal accounting and administrative controls used in administering a federal financial assistance program, the CPA should

- a. Communicate those weaknesses that are material in relation to the general purpose financial statements.
- b. Express an opinion on the systems used to administer major federal financial assistance programs and express negative assurance on the systems used to administer nonmajor federal financial assistance programs.
- c. Communicate those weaknesses that are material in relation to the federal financial assistance program.
- d. Express negative assurance on the systems used to administer major federal financial assistance programs and express **no** opinion on the systems used to administer nonmajor federal financial assistance programs.

Selected Questions

N88

Item 60 is based on the following flowchart:



60. In a credit sales and cash receipts system flowchart symbol X could represent

- a. Auditor's test data.
- b. Remittance advices.
- c. Error reports.
- d. Credit authorization forms.

M88#15. A CPA's report expressing an opinion on an entity's internal accounting control system identified several material weaknesses and will be published in the entity's annual report to shareholders. Management intends to include a statement asserting that the cost of correcting the weaknesses would exceed the benefits of reducing the risk of errors and irregularities. The CPA should

- a. Insist that management's statement **not** appear in the same document as the CPA's report.
- b. Investigate whether the cost of correcting the weaknesses would, in fact, exceed the benefits.
- c. Insist that management correct the weaknesses if cost is the only consideration.
- d. Not express any opinion as to management's statement.

M88#16. A CPA's study and evaluation of the system of internal accounting control in an audit will generally

- a. Be the same as that made in connection with an engagement to express an opinion on the system of internal accounting control.

- b. Result in the CPA expressing an opinion on the system of internal accounting control.
- c. Be more limited than that made in connection with an engagement to express an opinion on the system of internal accounting control.
- d. Be more extensive than that made in connection with an engagement to express an opinion on the system of internal accounting control.

N87#16. A flowchart is most frequently used by an auditor in connection with the

- a. Preparation of generalized computer audit programs.
- b. Review of the client's internal accounting controls.
- c. Use of statistical sampling in performing an audit.
- d. Performance of analytical review procedures of account balances.

N87#51. Which of the following statements is correct concerning the auditor's required communication of material weaknesses in internal accounting control?

- a. If the auditor does **not** become aware of any material weaknesses during the examination, that fact must be communicated.
- b. Weaknesses reported at interim dates should be tested for correction before completion of the engagement.
- c. Although written communication is preferable, the auditor may communicate the findings orally.
- d. Weaknesses reported at interim dates must be repeated in the communication at the completion of the engagement.

N87#52. The accountant's report expressing an opinion on an entity's system of internal accounting control should state that the

- a. Study and evaluation of the system of internal accounting control was conducted in accordance with generally accepted auditing standards.
- b. Establishment and maintenance of the system of internal accounting control are the responsibilities of management.
- c. Inherent limitations of any system of internal accounting control may prevent the preparation of financial statements in accordance with generally accepted accounting principles.
- d. Client's management has provided assurance that the expected benefits of the internal accounting control procedures are in excess of their related costs.

Auditing

N87#57. When assessing the tolerable rate, the auditor should consider that, while deviations from control procedures increase the risk of material errors, such deviations do not necessarily result in errors. This explains why

- a. A recorded disbursement that does **not** show evidence of required approval may nevertheless be a transaction that is properly authorized and recorded.
- b. Deviations would result in errors in the accounting records only if the deviations and the errors occurred on different transactions.
- c. Deviations from pertinent control procedures at a given rate ordinarily would be expected to result in errors at a higher rate.
- d. A recorded disbursement that is properly authorized may nevertheless be a transaction that contains a material error.

N87#58. The expected population deviation rate of client billing errors is 3%. The auditor has established a tolerable rate of 5%. In the review of client invoices the auditor should use

- a. Stratified sampling.
- b. Variable sampling.
- c. Discovery sampling.
- d. Attribute sampling.

N87#59. The risk of incorrect acceptance and the risk of overreliance on internal accounting control relate to the

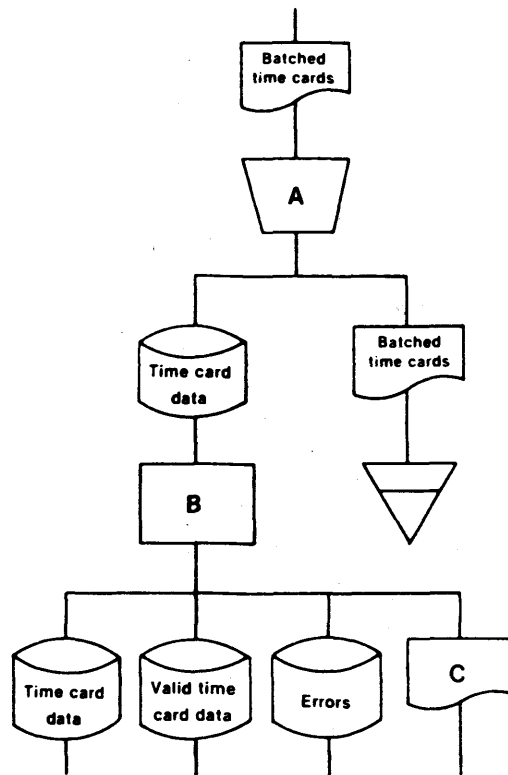
- a. Preliminary estimates of materiality levels.
- b. Allowable risk of tolerable error.
- c. Efficiency of the audit.
- d. Effectiveness of the audit.

M87#19. The auditor's communication of material weaknesses in internal accounting control is

- a. Required to enable the auditor to state that the examination has been made in accordance with generally accepted auditing standards.
- b. The principal reason for studying and evaluating the system of internal accounting controls.
- c. Incident to the auditor's objective of forming an opinion as to the fair presentation of the financial statements.
- d. Required to be documented in a written report to the board of directors or the board's audit committee.

M87

Items 24 through 26 are based on the following section of a system flowchart for a payroll application:



24. Symbol A could represent
 - a. Computation of gross pay.
 - b. Input of payroll data.
 - c. Preparation of paychecks.
 - d. Verification of payrates.
25. Symbol B could represent
 - a. Computation of net pay.
 - b. Separation of erroneous time cards.
 - c. Validation of payroll data.
 - d. Preparation of the payroll register.
26. Symbol C could represent
 - a. Batched time cards.
 - b. Unclaimed payroll checks.
 - c. Erroneous time cards.
 - d. An error report.


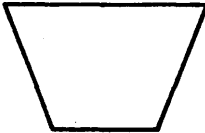


N86#20. When performing a compliance test with respect to control over cash receipts, an auditor may use a systematic sampling technique with a start at any

Selected Questions

randomly selected item. The biggest disadvantage of this type of sampling is that the items in the population

- a. Must be systematically replaced in the population after sampling.
- b. May systematically occur more than once in the sample.
- c. Must be recorded in a systematic pattern before the sample can be drawn.
- d. May occur in a systematic pattern, thus destroying the sample randomness.

M86#47. Which of the following flowchart symbols represents online storage?

- a. 
- b. 
- c. 
- d. 

N85#29. In estimation sampling for variables, which of the following must be known in order to estimate the appropriate sample size required to meet the auditor's needs in a given situation?

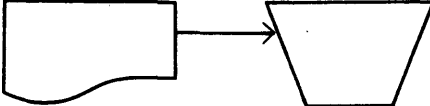
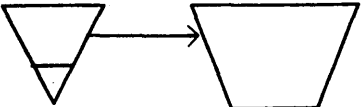
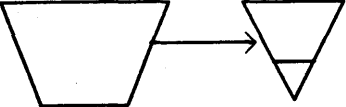
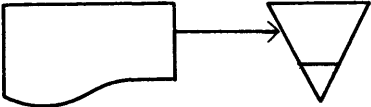
- a. The qualitative aspects of errors.
- b. The total dollar amount of the population.
- c. The acceptable level of risk.
- d. The estimated rate of error in the population.

N85#30. When an independent auditor reports on internal accounting control based on criteria established by governmental agencies, the report should

- a. Not include the agency's name in the report.
- b. Indicate matters covered by the study and whether the auditor's study included tests of compliance with the procedures covered by the study.

- c. Not express a conclusion based on the agency's criteria.
- d. Assume responsibility for the comprehensiveness of the criteria established by the agency and include recommendations for corrective action.

N85#60. Which of the following symbolic representations indicates that a sales invoice has been filed?

- a. 
- b. 
- c. 
- d. 

M85#23. An underlying feature of random-based selection of items is that each

- a. Stratum of the accounting population be given equal representation in the sample.
- b. Item in the accounting population be randomly ordered.
- c. Item in the accounting population should have an opportunity to be selected.
- d. Item must be systematically selected using replacement.

M85#35. In performing compliance testing, the auditor will normally find that

- a. The level of risk is directly proportionate to the rate of error.
- b. The rate of deviations in the sample exceeds the rate of error in the accounting records.
- c. The rate of error in the sample exceeds the rate of deviations.
- d. All unexamined items result in errors in the accounting records.

Auditing

M85#54. During the audit the independent auditor identified the existence of a material weakness in the client's system of internal accounting controls and orally communicated this finding to the client's senior management and audit committee. The auditor should

- a. Consider the material weakness a scope limitation and therefore disclaim an opinion.

- b. Document the matter in the working papers and consider the effects of the weakness on the audit.
- c. Suspend all audit activities pending directions from the client's audit committee.
- d. Withdraw from the engagement.

III. Evidence and Procedures

A. Audit Evidence

M89#1. Each of the following might, by itself, form a valid basis for an auditor to decide to omit a test **except** for the

- a. Difficulty and expense involved in testing a particular item.
- b. Degree of reliance on the relevant internal controls.
- c. Relative risk involved.
- d. Relationship between the cost of obtaining evidence and its usefulness.

M89#27. The primary objective of analytical procedures used in the final review stage of an audit is to

- a. Obtain evidence from details tested to corroborate particular assertions.
- b. Identify areas that represent specific risks relevant to the audit.
- c. Assist the auditor in assessing the validity of the conclusions reached.
- d. Satisfy doubts when questions arise about a client's ability to continue in existence.

M89#28. To help plan the nature, timing, and extent of substantive auditing procedures, preliminary analytical procedures should focus on

- a. Enhancing the auditor's understanding of the client's business and events that have occurred since the last audit date.
- b. Developing plausible relationships that corroborate anticipated results with a measurable amount of precision.
- c. Applying ratio analysis to externally generated data such as published industry statistics or price indices.
- d. Comparing recorded financial information to the results of other tests of transactions and balances.

M89#29. Cooper, CPA, is auditing the financial statements of a small rural municipality. The receivable balances represent residents' delinquent real estate taxes.

The internal control structure at the municipality is weak. To determine the existence of the accounts receivable balances at the balance sheet date, Cooper would most likely

- a. Send positive confirmation requests.
- b. Send negative confirmation requests.
- c. Examine evidence of subsequent cash receipts.
- d. Inspect the internal records such as copies of the tax invoices that were mailed to the residents.

M89#30. An auditor would most likely verify the interest earned on bond investments by

- a. Vouching the receipt and deposit of interest checks.
- b. Confirming the bond interest rate with the issuer of the bonds.
- c. Recomputing the interest earned on the basis of face amount, interest rate, and period held.
- d. Testing the internal controls over cash receipts.

M89#32. Auditors should request that an audit client send a letter of inquiry to those attorneys who have been consulted concerning litigation, claims, or assessments. The primary reason for this request is to provide

- a. Information concerning the progress of cases to date.
- b. Corroborative evidential matter.
- c. An estimate of the dollar amount of the probable loss.
- d. An expert opinion as to whether a loss is possible, probable, or remote.

M89#34. A written client representation letter most likely would be an auditor's best source of corroborative information of a client's plans to

- a. Terminate an employee pension plan.
- b. Make a public offering of its common stock.
- c. Settle an outstanding lawsuit for an amount less than the accrued loss contingency.
- d. Discontinue a line of business.

Selected Questions

N88#51. A basic premise underlying analytical review procedures is that

- a. These procedures can **not** replace tests of balances and transactions.
- b. Statistical tests of financial information may lead to the discovery of material errors in the financial statements.
- c. The study of financial ratios is an acceptable alternative to the investigation of unusual fluctuations.
- d. Relationships among data may reasonably be expected to exist and continue in the absence of known conditions to the contrary.

N88#52. An auditor who uses the work of a specialist may refer to and identify the specialist in the auditor's report if the

- a. Specialist is also considered to be a related party.
- b. Auditor indicates a division of responsibility related to the work of the specialist.
- c. Specialist's work provides the auditor greater assurance of reliability.
- d. Auditor expresses an "except for" qualified opinion or an adverse opinion related to the work of the specialist.

N88#53. An auditor should obtain evidential matter relevant to all the following factors concerning third-party litigation against a client **except** the

- a. Period in which the underlying cause for legal action occurred.
- b. Probability of an unfavorable outcome.
- c. Jurisdiction in which the matter will be resolved.
- d. Existence of a situation indicating an uncertainty as to the possible loss.

M88#21. Which of the following statements is generally correct about the competence of evidential matter?

- a. The auditor's direct personal knowledge, obtained through observation and inspection, is more persuasive than information obtained indirectly from independent outside sources.
- b. To be competent, evidential matter must be either valid or relevant, but need **not** be both.
- c. Accounting data alone may be considered sufficient competent evidential matter to issue an unqualified opinion on financial statements.
- d. Competence of evidential matter refers to the amount of corroborative evidence to be obtained.

M88#22. To establish the existence and ownership of a long-term investment in the common stock of a publicly-traded company, an auditor ordinarily performs a security count or

- a. Relies on the client's internal accounting controls if the auditor has reasonable assurance

that the control procedures are being applied as prescribed.

- b. Confirms the number of shares owned that are held by an independent custodian.
- c. Determines the market price per share at the balance sheet date from published quotations.
- d. Confirms the number of shares owned with the issuing company.

M88#23. If a client maintains perpetual inventory records in quantities and in dollars, and its internal accounting control over inventory is weak, an auditor would probably

- a. Apply gross profit tests to ascertain the reasonableness of the physical counts.
- b. Increase the extent of compliance tests of the inventory cycle.
- c. Request the client to schedule the physical inventory count at the end of the year.
- d. Insist that the client perform physical counts of inventory items several times during the year.

M88#24. An auditor testing long-term investments would ordinarily use analytical review as the primary audit procedure to ascertain the reasonableness of the

- a. Valuation of marketable equity securities.
- b. Classification of gains and losses on the disposal of securities.
- c. Completeness of recorded investment income.
- d. Existence and ownership of investments.

M88#46. "Provision has been made for any material loss that might be sustained as a result of purchase commitments for inventory quantities in excess of normal requirements or at prices in excess of the prevailing market prices." The foregoing passage is most likely from

- a. A management representation letter.
- b. The explanatory paragraph of an "except for" qualified auditor's report.
- c. A vendor representation letter.
- d. The explanatory paragraph of a "subject to" qualified auditor's report.

N87#32. When considering the use of management's written representations as audit evidence about the completeness assertion, an auditor should understand that such representations

- a. Complement, but do **not** replace, substantive tests designed to support the assertion.
- b. Constitute sufficient evidence to support the assertion when considered in combination with reliance on internal accounting controls.
- c. Are **not** part of the evidential matter considered to support the assertion.
- d. Replace reliance on internal accounting controls as evidence to support the assertion.

Auditing

N87#33. One reason why an auditor makes an analytical review of the client's operations is to identify

- a. Improper separation of accounting and other financial duties.
- b. Weaknesses of a material nature in the system of internal accounting control.
- c. Unusual transactions.
- d. Non-compliance with prescribed control procedures.

N87#34. After accounting for a sequence of inventory tags, an auditor traces a sample of tags to the physical inventory listing to obtain evidence that all items

- a. Included in the listing have been counted.
- b. Represented by inventory tags are included in the listing.
- c. Included in the listing are represented by inventory tags.
- d. Represented by inventory tags are bona fide.

N87#35. Which of the following statements ordinarily is included among the written client representations obtained by the auditor?

- a. Sufficient evidential matter has been made available to permit the issuance of an unqualified opinion.
- b. Compensating balances and other arrangements involving restrictions on cash balances have been disclosed.
- c. Management acknowledges responsibility for illegal actions committed by employees.
- d. Management acknowledges that there are no material weaknesses in internal accounting controls.

N87#36. An attorney responding to an auditor as a result of the client's letter of audit inquiry may appropriately limit the response to

- a. Items which have high probability of being resolved to the client's detriment.
- b. Asserted claims and pending or threatened litigation.
- c. Legal matters subject to unsettled points of law, uncorroborated information, or other complex judgments.
- d. Matters to which the attorney has given substantive attention in the form of legal consultation or representation.

M87#3. An abnormal fluctuation in gross profit that might suggest the need for extended audit procedures for sales and inventories would most likely be identified in the planning phase of the audit by the use of

- a. Tests of transactions and balances.
- b. A preliminary review of internal accounting control.
- c. Specialized audit programs.
- d. Analytical review procedures.

M87#23. When there are a large number of relatively small account balances, negative confirmation of ac-

counts receivable is feasible if internal accounting control is

- a. Strong, and the individuals receiving the confirmation requests are unlikely to give them adequate consideration.
- b. Weak, and the individuals receiving the confirmation requests are likely to give them adequate consideration.
- c. Weak, and the individuals receiving the confirmation requests are unlikely to give them adequate consideration.
- d. Strong, and the individuals receiving the confirmation requests are likely to give them adequate consideration.

M87#27. Audit evidence can come in different forms with different degrees of persuasiveness. Which of the following is the **least** persuasive type of evidence?

- a. Bank statement obtained from the client.
- b. Computations made by the auditor.
- c. Prenumbered client sales invoices.
- d. Vendor's invoice.

M87#28. An example of an analytical review procedure is the comparison of

- a. Financial information with similar information regarding the industry in which the entity operates.
- b. Recorded amounts of major disbursements with appropriate invoices.
- c. Results of a statistical sample with the expected characteristics of the actual population.
- d. EDP generated data with similar data generated by a manual accounting system.

M87#30. When auditing merchandise inventory at year-end, the auditor performs a purchase cutoff test to obtain evidence that

- a. All goods purchased before year-end are received before the physical inventory count.
- b. No goods held on consignment for customers are included in the inventory balance.
- c. No goods observed during the physical count are pledged or sold.
- d. All goods owned at year-end are included in the inventory balance.

M87#31. Which of the following is the most effective audit procedure for verification of dividends earned on investments in marketable equity securities?

- a. Tracing deposit of dividend checks to the cash receipts book.
- b. Reconciling amounts received with published dividend records.
- c. Comparing the amounts received with preceding year dividends received.
- d. Recomputing selected extensions and footings of dividend schedules and comparing totals to the general ledger.

Selected Questions

M87#32. Which of the following auditing procedures is ordinarily performed last?

- a. Obtaining a management representation letter.
- b. Testing the purchasing function.
- c. Reading the minutes of directors' meetings.
- d. Confirming accounts payable.

M87#46. Which of the following statements concerning the auditor's use of the work of a specialist is correct?

- a. If the specialist is related to the client, the auditor is **not** permitted to use the specialist's findings as corroborative evidence.
- b. The specialist may be identified in the auditor's report only when the auditor issues a qualified opinion.
- c. The specialist should have an understanding of the auditor's corroborative use of the specialist's findings.
- d. If the auditor believes that the determinations made by the specialist are unreasonable, only an adverse opinion may be issued.

N86#28. The auditor's analytical review will be facilitated if the client

- a. Uses a standard cost system that produces variance reports.
- b. Segregates obsolete inventory before the physical inventory count.
- c. Corrects material weaknesses in internal accounting control before the beginning of the audit.
- d. Reduces inventory balances to the lower of cost or market.

N86#29. Which of the following audit procedures would provide the **least** reliable evidence that the client has legal title to inventories?

- a. Confirmation of inventories at locations outside the client's facilities.
- b. Analytical review of inventory balances compared to purchasing and sales activities.
- c. Observation of physical inventory counts.
- d. Examination of paid vendors' invoices.

N86#30. An aged trial balance of accounts receivable is usually used by the auditor to

- a. Verify the validity of recorded receivables.
- b. Ensure that all accounts are promptly credited.
- c. Evaluate the results of compliance tests.
- d. Evaluate the provision for bad debt expense.

N86#31. When an auditor is unable to inspect and count a client's investment securities until after the balance-sheet date, the bank where the securities are held in a safe deposit box should be asked to

- a. Verify any differences between the contents of the box and the balances in the client's subsidiary ledger.

- b. Provide a list of securities added and removed from the box between the balance-sheet date and the security-count date.
- c. Confirm that there has been **no** access to the box between the balance-sheet date and the security-count date.
- d. Count the securities in the box so the auditor will have an independent direct verification.

N86#32. Hall accepted an engagement to audit the 1985 financial statements of XYZ Company. XYZ completed the preparation of the 1985 financial statements on February 13, 1986, and Hall began the field work on February 17, 1986. Hall completed the field work on March 24, 1986, and completed the report on March 28, 1986. The client's representation letter normally would be dated

- a. February 13, 1986.
- b. February 17, 1986.
- c. March 24, 1986.
- d. March 28, 1986.

N86#34. The auditor's primary means of obtaining corroboration of management's information concerning litigation is a

- a. Letter of audit inquiry to the client's lawyer.
- b. Letter of corroboration from the auditor's lawyer upon review of the legal documentation.
- c. Confirmation of claims and assessments from the other parties to the litigation.
- d. Confirmation of claims and assessments from an officer of the court presiding over the litigation.

N86#47. The third standard of field work states that sufficient competent evidential matter may, in part, be obtained through inspection, observation, inquiries, and confirmations to afford a reasonable basis for an opinion regarding the financial statements under examination. The evidential matter required by this standard may, in part, be obtained through

- a. Analytical review procedures.
- b. Auditor working papers.
- c. Review of the system of internal accounting control.
- d. Proper planning of the audit engagement.

M86#2. Purchase cutoff procedures should be designed to test whether or **not** all inventory

- a. Purchased and received before the end of the year was paid for.
- b. Ordered before the end of the year was received.
- c. Purchased and received before the end of the year was recorded.
- d. Owned by the company is in the possession of the company at the end of the year.

Auditing

M86#5. The primary reason an auditor requests letters of inquiry be sent to a client's attorneys is to provide the auditor with

- a. A description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet.
- b. An expert opinion as to whether a loss is possible, probable, or remote.
- c. The opportunity to examine the documentation concerning litigation, claims, and assessments.
- d. Corroboration of the information furnished by management concerning litigation, claims, and assessments.

M86#33. An auditor compares 1985 revenues and expenses with those of the prior year and investigates all changes exceeding 10%. By this procedure the auditor would be most likely to learn that

- a. Fourth quarter payroll taxes were **not** paid.
- b. The client changed its capitalization policy for small tools in 1985.
- c. An increase in property tax rates has **not** been recognized in the client's accrual.
- d. The 1985 provision for uncollectible accounts is inadequate because of worsening economic conditions.

M86#34. The auditor may conclude that depreciation charges are insufficient by noting

- a. Large amounts of fully depreciated assets.
- b. Continuous trade-ins of relatively new assets.
- c. Excessive recurring losses on assets retired.
- d. Insured values greatly in excess of book values.

M86#48. When an examination is made in accordance with generally accepted auditing standards, the auditor should always

- a. Document the auditor's understanding of the client's internal accounting control system.
- b. Employ analytical review procedures.
- c. Obtain certain written representations from management.
- d. Observe the taking of physical inventory on the balance sheet date.

N85

Items 21 through 26* are based on the following information:

Hickory, Inc., is a small manufacturer. Its office building, plant, and warehouse are all located in Zena, Ohio. William Cream is the principal owner and president of Hickory.

Hickory is not a publicly held corporation. The primary uses of the financial statements are for its 15 shareholders and for bank credit purposes. Hickory's financial statements have never been audited or reviewed.

On July 18, 1984, William Cream hired the CPA firm of Part & Co. to audit Hickory's financial statements for the year ended December 31, 1984. Part & Co. performed the audit field work from December 15, 1984, through March 10, 1985.

Part & Co. has offices in Cleveland, the office that performed the Hickory audit, and Chicago.

22. Hickory's client representation letter should be dated

- a. July 18, 1984.
- b. December 15, 1984.
- c. December 31, 1984.
- d. March 10, 1985.

N85#35. Which of the following is **not** one of the independent auditor's objectives regarding the examination of inventories?

- a. Verifying that inventory counted is owned by the client.
- b. Verifying that the client has used proper inventory pricing.
- c. Ascertaining the physical quantities of inventory on hand.
- d. Verifying that all inventory owned by the client is on hand at the time of the count.

N85#44. Which of the following is **least** likely to include a reference to the use of a specialist?

- a. Unqualified opinion.
- b. Adverse opinion.
- c. "Except for" qualified opinion.
- d. "Subject to" qualified opinion.

N85#45. Which of the following is **not** an audit procedure which the independent auditor would perform with respect to litigation, claims, and assessments?

- a. Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
- b. Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the balance sheet date.
- c. Obtain assurance from management that it has disclosed all unasserted claims that the lawyer has advised are probable of assertion and must be disclosed.
- d. Confirm directly with the client's lawyer that all claims have been recorded in the financial statements.

N85#47. Which of the following would provide the best form of evidential matter pertaining to the annual

*The items omitted can be found in other Content Specification Groups.

Selected Questions

valuation of a long-term investment in which the independent auditor's client owns a 30% voting interest?

- a. Market quotations of the investee company's stock.
- b. Current fair value of the investee company's assets.
- c. Historical cost of the investee company's assets.
- d. Audited financial statements of the investee company.

M85#13. An auditor accepted an engagement to audit the 1984 financial statements of EFG Corporation and began the field work on September 30, 1984. EFG gave the auditor the 1984 financial statements on January 17, 1985. The auditor completed the field work on February 10, 1985 and delivered the report on February 16, 1985. The client's representation letter normally would be dated

- a. December 31, 1984.
- b. January 17, 1985.
- c. February 10, 1985.
- d. February 16, 1985.

M85#46. In using the work of a specialist, an understanding should exist among the auditor, the client, and the specialist as to the nature of the work to be performed by the specialist. Preferably, the understanding should be documented and would include all of the following, **except**

- a. The objectives and scope of the specialist's work.
- b. The specialist's representations as to his relationship, if any, to the client.
- c. The specialist's understanding of the auditor's corroborative use of the specialist's findings in relation to the representations in the financial statements.
- d. A statement that the methods or assumptions to be used are **not** inconsistent with those used by the client.

M85#47. When perpetual inventory records are maintained in quantities and in dollars, and internal accounting control over inventory is weak, the auditor would probably

- a. Want the client to schedule the physical inventory count at the end of the year.
- b. Insist that the client perform physical counts of inventory items several times during the year.
- c. Increase the extent of tests for unrecorded liabilities at the end of the year.
- d. Have to disclaim an opinion on the income statement for that year.

M85#56. Which of the following statements regarding the audit of negotiable notes receivable is **not** correct?

- a. Confirmation from the debtor is an acceptable alternative to inspection.
- b. Materiality of the amount involved is a factor considered when selecting the accounts to be confirmed.
- c. Physical inspection of a note by the auditor does **not** provide conclusive evidence.
- d. Notes receivable discounted with recourse need to be confirmed.

M85#58. The audit inquiry letter to the client's legal counsel should be mailed only by the

- a. Client after the auditor has reviewed it for appropriate content.
- b. Auditor after preparation by the client and review by the auditor.
- c. Auditor's attorney after preparation by the client and review by the auditor.
- d. Client after review by the auditor's attorney.

B. Specific Audit Objectives and Procedures

M89#31. Which of the following most likely would be detected by an auditor's review of a client's sales cut-off?

- a. Unrecorded sales for the year.
- b. Lapping of year-end accounts receivable.
- c. Excessive sales discounts.
- d. Unauthorized goods returned for credit.

M89#33. Tracing selected items from the payroll register to employee time cards that have been approved by supervisory personnel provides evidence that

- a. Internal controls relating to payroll disbursements were operating effectively.
- b. Payroll checks were signed by an appropriate officer independent of the payroll preparation process.
- c. Only bona fide employees worked and their pay was properly computed.
- d. Employees worked the number of hours for which their pay was computed.

M89#35. In an audit of contingent liabilities, which of the following procedures would be **least** effective?

- a. Reviewing a bank confirmation letter.
- b. Examining customer confirmation replies.
- c. Examining invoices for professional services.
- d. Reading the minutes of the board of directors.

Auditing

M89

Items 36 and 37 are based on the following:

Miles Company Bank Transfer Schedule December 31, 1988

Check Number	Bank Accounts		Amount	Date disbursed per		Date deposited per	
	From	To		Books	Bank	Books	Bank
2020	1st Natl.	Suburban	\$32,000	12/31	1/5 ♦	12/31	1/3 ▲
2021	1st Natl.	Capital	21,000	12/31	1/4 ♦	12/31	1/3 ▲
3217	2nd State	Suburban	6,700	1/3	1/5	1/3	1/6
0659	Midtown	Suburban	5,500	12/30	1/5 ♦	12/30	1/3 ▲

36. The tick mark ♦ most likely indicates that the amount was traced to the

- December cash disbursements journal.
- Outstanding checklist of the applicable bank reconciliation.
- January cash disbursements journal.
- Year-end bank confirmations.

37. The tick mark ▲ most likely indicates that the amount was traced to the

- Deposits in transit of the applicable bank reconciliation.
- December cash receipts journal.
- January cash receipts journal.
- Year-end bank confirmations.

N88#54. An auditor analyzes repairs and maintenance accounts primarily to obtain evidence in support of the audit assertion that all

- Noncapitalizable expenditures for repairs and maintenance have been properly charged to expense.
- Expenditures for property and equipment have **not** been charged to expense.
- Noncapitalizable expenditures for repairs and maintenance have been recorded in the proper period.
- Expenditures for property and equipment have been recorded in the proper period.

N88#55. For which of the following account balances are substantive tests of details **least** likely to be performed unless analytical review procedures indicate the need to extend detail testing?

- Payroll expense.
- Marketable securities.
- Research and development costs.
- Legal expense.

N88#56. Which of the following statements concerning working papers is incorrect?

- An auditor may support an opinion by other means in addition to working papers.
- The form of working papers should be designed to meet the circumstances of a particular engagement.
- An auditor's working papers may **not** serve as a reference source for the client.
- Working papers should show that the internal accounting control system has been studied and evaluated to the degree necessary.

M88#26. Which of the following cash transfers results in a misstatement of cash at December 31, 1987?

Transfer	Bank Transfer Schedule			
	Disbursement		Receipt	
	Recorded in books	Paid by bank	Recorded in books	Received by bank
a.	12/31/87	1/4/88	12/31/87	12/31/87
b.	1/4/88	1/5/88	12/31/87	1/4/88
c.	12/31/87	1/5/88	12/31/87	1/4/88
d.	1/4/88	1/11/88	1/4/88	1/4/88

M88#27. An auditor should trace corporate stock issuances and treasury stock transactions to the

- Numbered stock certificates.
- Articles of incorporation.
- Transfer agent's records.
- Minutes of the board of directors.

M88#28. Which of the following procedures would an auditor most likely rely on to verify management's assertion of completeness?

- Review standard bank confirmations for indications of kiting.
- Compare a sample of shipping documents to related sales invoices.
- Observe the client's distribution of payroll checks.
- Confirm a sample of recorded receivables by direct communication with the debtors.

M88#29. Working papers ordinarily would **not** include

- Initials of the in-charge auditor indicating review of the staff assistants' work.
- Cut-off bank statements received directly from the banks.

Selected Questions

- c. A memo describing the preliminary review of the internal accounting control system.
 - d. Copies of client inventory count sheets.
- M88#39.** The current file of the auditor's working papers generally should include
- a. A flowchart of the internal accounting controls.
 - b. Organization charts.
 - c. A copy of the financial statements.
 - d. Copies of bond and note indentures.
- M87#31.** An audit working paper that reflects the major components of an amount reported in the financial statements is referred to as a(an)
- a. Lead schedule.
 - b. Supporting schedule.
 - c. Audit control account.
 - d. Working trial balance.
- M87#37.** An auditor's program for the examination of long-term debt should include steps that require the
- a. Inspection of the accounts payable subsidiary ledger.
 - b. Investigation of credits to the bond interest income account.
 - c. Verification of the existence of the bondholders.
 - d. Examination of any bond trust indenture.
- M87#36.** On receiving the bank cutoff statement, the auditor should trace
- a. Deposits in transit on the year-end bank reconciliation to deposits in the cash receipts journal.
 - b. Checks dated prior to year-end to the outstanding checks listed on the year-end bank reconciliation.
 - c. Deposits listed on the cutoff statement to deposits in the cash receipts journal.
 - d. Checks dated subsequent to year-end to the outstanding checks listed on the year-end bank reconciliation.
- M87#37.** An auditor ordinarily should send a standard confirmation request to all banks with which the client has done business during the year under audit, regardless of the year-end balance, because this procedure
- a. Provides for confirmation regarding compensating balance arrangements.
 - b. Detects kiting activities that may otherwise not be discovered.
 - c. Seeks information about indebtedness to the bank.
 - d. Verifies securities held by the bank in safe-keeping.
- M87#38.** Which of the following is the best audit procedure for determining the existence of unrecorded liabilities at year-end?
- a. Examine a sample of invoices dated a few days prior to and subsequent to year-end to ascertain whether they have been properly recorded.
 - b. Examine a sample of cash disbursements in the period subsequent to year-end.
 - c. Examine confirmation requests returned by creditors whose accounts appear on a subsidiary trial balance of accounts payable.
 - d. Examine unusual relationships between monthly accounts payable balances and recorded purchases.
- M87#43.** Working papers that record the procedures used by the auditor to gather evidence should be
- a. Considered the primary support for the financial statements being examined.
 - b. Viewed as the connecting link between the books of account and the financial statements.
 - c. Designed to meet the circumstances of the particular engagement.
 - d. Destroyed when the audited entity ceases to be a client.
- N86#38.** An auditor would be most likely to identify a contingent liability by obtaining a(an)
- a. Related party transaction confirmation.
 - b. Accounts payable confirmation.
 - c. Transfer agent confirmation.
 - d. Standard bank confirmation.
- N86#39.** Which of the following might be detected by an auditor's review of the client's sales cut-off?
- a. Excessive goods returned for credit.
 - b. Unrecorded sales discounts.
 - c. Lapping of year-end accounts receivable.
 - d. Inflated sales for the year.
- N86#43.** Confirmation is most likely to be a relevant form of evidence with regard to assertions about accounts receivable when the auditor has concerns about the receivables'
- a. Valuation.
 - b. Classification.
 - c. Existence.
 - d. Completeness.
- M86#42.** The permanent file section of the working papers that is kept for each audit client most likely contains
- a. Review notes pertaining to questions and comments regarding the audit work performed.
 - b. A schedule of time spent on the engagement by each individual auditor.
 - c. Correspondence with the client's legal counsel concerning pending litigation.
 - d. Narrative descriptions of the client's accounting procedures and internal accounting controls.

Auditing

N85#42. To test for unsupported entries in the ledger, the direction of audit testing should be from the

- a. Journal entries.
- b. Ledger entries.
- c. Original source documents.
- d. Externally generated documents.

N85#43. Which of the following procedures is **least** likely to be performed before the balance sheet date?

- a. Confirmation of receivables.
- b. Search for unrecorded liabilities.
- c. Observation of inventory.
- d. Review of internal accounting control over cash disbursements.

N85#49. Which of the following statements about working papers is correct?

- a. Working papers are **not** permitted to be used as a reference source by the client.
- b. Documentation of an auditor's understanding of client's internal accounting control system may **not** be necessary.
- c. Working papers may be regarded as a substitute for the client's accounting records.
- d. When reporting on comparative financial statements the independent auditor may discard working papers after two years.

M85#29. To gather evidence regarding the balance per bank in a bank reconciliation, an auditor would examine all of the following **except**

- a. Cutoff bank statement.
- b. Year-end bank statement.
- c. Bank confirmation.
- d. General ledger.

M85#39. Two months before year-end the bookkeeper erroneously recorded the receipt of a long-term bank loan by a debit to cash and a credit to sales. Which of the following is the most effective procedure for detecting this type of error?

- a. Analyze the notes payable journal.
- b. Analyze bank confirmation information.
- c. Prepare a year-end bank reconciliation.
- d. Prepare a year-end bank transfer schedule.

C. Other Specific Audit Topics

M89#38. Which of the following is **not** a major reason why an accounting audit trail should be maintained for a computer system?

- a. Monitoring purposes.
- b. Analytical procedures.
- c. Query answering.
- d. Deterrent to irregularities.

M89#39. Which of the following computer-assisted auditing techniques allows fictitious and real transactions to be processed together without client operating personnel being aware of the testing process?

- a. Parallel simulation.
- b. Generalized audit software programming.
- c. Integrated test facility.
- d. Test data approach.

M89#40. In a probability-proportional-to-size sample with a sampling interval of \$10,000, an auditor discovered that a selected account receivable with a recorded amount of \$5,000 had an audit amount of \$2,000. The projected error of this sample was

- a. \$3,000.
- b. \$4,000.
- c. \$6,000.
- d. \$8,000.

M89#41. An auditor is performing substantive tests of pricing and extensions of perpetual inventory balances consisting of a large number of items. Past experience indicates numerous pricing and extension errors. Which of the following statistical sampling approaches is most appropriate?

- a. Unstratified mean-per-unit.
- b. Probability-proportional-to-size.
- c. Stop or go.
- d. Ratio estimation.

M89#42. An auditor searching for related party transactions should obtain an understanding of each subsidiary's relationship to the total entity because

- a. This may permit the audit of intercompany account balances to be performed as of concurrent dates.
- b. Intercompany transactions may have been consummated on terms equivalent to arm's-length transactions.
- c. This may reveal whether particular transactions would have taken place if the parties had **not** been related.
- d. The business structure may be deliberately designed to obscure related party transactions.

M89#43. A typical objective of an operational audit is to determine whether an entity's

- a. Internal control structure is adequately operating as designed.
- b. Operational information is in accordance with generally accepted governmental auditing standards.

Selected Questions

- c. Financial statements present fairly the results of operations.
- d. Specific operating units are functioning efficiently and effectively.

M89#44. An auditor concludes that the omission of a substantive procedure considered necessary at the time of the examination may impair the auditor's present ability to support the previously expressed opinion. The auditor need **not** apply the omitted procedure if

- a. The risk of adverse publicity or litigation is low.
- b. The results of other procedures that were applied tend to compensate for the procedure omitted.
- c. The auditor's opinion was qualified because of a departure from generally accepted accounting principles.
- d. The results of the subsequent period's tests of controls make the omitted procedure less important.

N88#8. Which of the following procedures would an auditor ordinarily perform during the review of subsequent events?

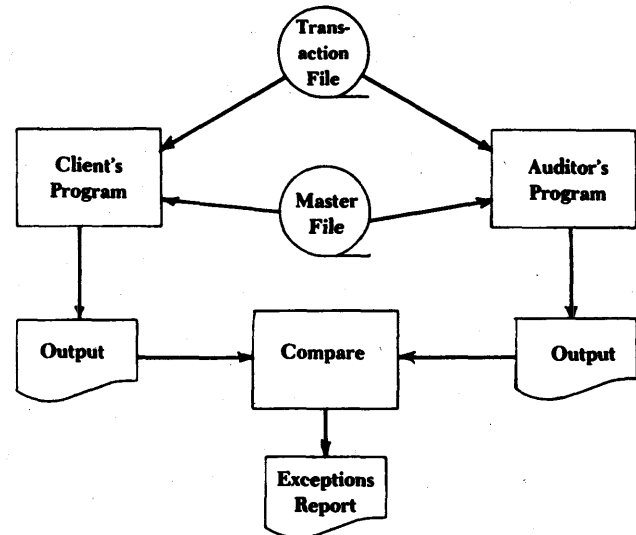
- a. An analysis of related party transactions for the discovery of possible irregularities.
- b. A review of the cut-off bank statements for the period after the year-end.
- c. An inquiry of the client's legal counsel concerning litigation.
- d. An investigation of material weaknesses in internal accounting control previously communicated to the client.

N88#57. The two requirements crucial to achieving audit efficiency and effectiveness with a microcomputer are selecting

- a. The appropriate audit tasks for microcomputer applications and the appropriate software to perform the selected audit tasks.
- b. The appropriate software to perform the selected audit tasks and client data that can be accessed by the auditor's microcomputer.
- c. Client data that can be accessed by the auditor's microcomputer and audit procedures that are generally applicable to several clients in a specific industry.
- d. Audit procedures that are generally applicable to several clients in a specific industry and the appropriate audit tasks for microcomputer applications.

N88

Item 59 is based on the following flowchart:



59. The above flowchart depicts
- a. Program code checking.
 - b. Parallel simulation.
 - c. Integrated test facility.
 - d. Controlled reprocessing.

M88#17. Using microcomputers in auditing may affect the methods used to review the work of staff assistants because

- a. Supervisory personnel may **not** have an understanding of the capabilities and limitations of microcomputers.
- b. Working paper documentation may **not** contain readily observable details of calculations.
- c. The audit field work standards for supervision may differ.
- d. Documenting the supervisory review may require assistance of management services personnel.

M88#31. Processing data through the use of simulated files provides an auditor with information about the reliability of controls. One of the techniques involved in this approach makes use of

- a. Controlled reprocessing.
- b. Integrated test facility.
- c. Input validation.
- d. Program code checking.

Auditing

M88#33. A number of factors influences the sample size for a substantive test of details of an account balance. All other factors being equal, which of the following would lead to a larger sample size?

- Greater reliance on internal accounting controls.
- Greater reliance on analytical review procedures.
- Smaller expected frequency of errors.
- Smaller measure of tolerable error.

M88#34. Which of the following statements is correct concerning the auditor's use of statistical sampling?

- An auditor needs to estimate the dollar amount of the standard deviation of the population to use classical variables sampling.
- An assumption of PPS sampling is that the underlying accounting population is normally distributed.
- A classical variables sample needs to be designed with special considerations to include negative balances in the sample.
- The selection of zero balances usually does **not** require special sample design considerations when using PPS sampling.

M88#35. Which of the following statements is correct concerning related party transactions?

- In the absence of evidence to the contrary, related party transactions should be assumed to be outside the ordinary course of business.
- An auditor should determine whether a particular transaction would have occurred if the parties had **not** been related.
- An auditor should substantiate that related party transactions were consummated on terms equivalent to those that prevail in arm's-length transactions.
- The audit procedures directed toward identifying related party transactions should include considering whether transactions are occurring, but are **not** being given proper accounting recognition.

M88#36. Ajax Company's auditor concludes that the omission of an audit procedure considered necessary at the time of the prior examination impairs the auditor's present ability to support the previously expressed unqualified opinion. If the auditor believes there are stockholders currently relying on the opinion, the auditor should promptly

- Notify the stockholders currently relying on the previously expressed unqualified opinion that they should **not** rely on it.
- Advise management to disclose this development in its next interim report to the stockholders.
- Advise management to revise the financial statements with full disclosure of the auditor's inability to support the unqualified opinion.
- Undertake to apply the omitted procedure or alternate procedures that would provide a satisfactory basis for the opinion.

M88#37. A governmental audit may extend beyond an examination leading to the expression of an opinion on the fairness of financial presentation to include

	<u>Program results</u>	<u>Compliance</u>	<u>Economy & efficiency</u>
a.	Yes	Yes	No
b.	Yes	Yes	Yes
c.	No	Yes	Yes
d.	Yes	No	Yes

M88#38. Which of the following procedures would an auditor most likely perform to obtain evidence about an entity's subsequent events?

- Reconcile bank activity for the month after the balance sheet date with cash activity reflected in the accounting records.
- Examine on a test basis the purchase invoices and receiving reports for several days after the inventory date.
- Review the treasurer's monthly reports on temporary investments owned, purchased, and sold.
- Obtain a letter from the entity's attorney describing any pending litigation, unasserted claims, or loss contingencies.

N87#6. An auditor who is determining the scope of work to be performed concerning possible related party transactions should

- Assume that transactions with related parties are outside the ordinary course of business.
- Determine whether transactions with related parties would have taken place if the parties had **not** been related.
- Obtain an understanding of management responsibilities and the relationship of each of the parties to the total entity.
- Establish a basis of accounting principles different from that which would have been appropriate had the parties **not** been related.

N87#38. Hill has decided to use Probability Proportional to Size (PPS) sampling, sometimes called dollar-unit sampling, in the audit of a client's accounts receivable balances. Hill plans to use the following PPS sampling table:

TABLE
Reliability Factors for Errors of Overstatement

<u>Number of over-statement errors</u>	<u>Risk of Incorrect Acceptance</u>				
	<u>1%</u>	<u>5%</u>	<u>10%</u>	<u>15%</u>	<u>20%</u>
0	4.61	3.00	2.31	1.90	1.6
1	6.64	4.75	3.89	3.38	3.00
2	8.41	6.30	5.33	4.72	4.28
3	10.05	7.76	6.69	6.02	5.52
4	11.61	9.16	8.00	7.27	6.73

Selected Questions

Additional Information

Tolerable error (net of effect of expected error)	\$ 24,000
Risk of incorrect acceptance	20%
Number of errors allowed	1
Recorded amount of accounts receivable	\$240,000
Number of accounts	360

What sample size should Hill use?

- a. 120
- b. 108
- c. 60
- d. 30

M87#33. After discovering that a related party transaction exists, the auditor should be aware that the

- a. Substance of the transaction could be significantly different from its form.
- b. Adequacy of disclosure of the transaction is secondary to its legal form.
- c. Transaction is assumed to be outside the ordinary course of business.
- d. Financial statements should recognize the legal form of the transaction rather than its substance.

M87#39. Operational auditing is primarily oriented toward

- a. Future improvements to accomplish the goals of management.
- b. The accuracy of data reflected in management's financial records.
- c. The verification that a company's financial statements are fairly presented.
- d. Past protection provided by existing internal accounting control.

M87#45. When using a computer to gather evidence, the auditor need **not** have working knowledge of the client's programming language. However, it is necessary that the auditor understand the

- a. Audit specifications.
- b. Programming techniques.
- c. Database retrieval system.
- d. Manual testing techniques.

M87#47. An auditor concludes that an audit procedure considered necessary at the time of the examination had been omitted. The auditor should assess the importance of the omitted procedure to the ability to support the previously expressed opinion. Which of the following would be **least** helpful in making that assessment?

- a. A discussion with the client about whether there are persons relying on the auditor's report.
- b. A reevaluation of the overall scope of the examination.

- c. A discussion of the circumstances with engagement personnel.
- d. A review of the other audit procedures that were applied that might compensate for the one omitted.

M87#48. A client acquired 25% of its outstanding capital stock after year-end and prior to completion of the auditor's fieldwork. The auditor should

- a. Advise management to adjust the balance sheet to reflect the acquisition.
- b. Issue pro forma financial statements giving effect to the acquisition as if it had occurred at year-end.
- c. Advise management to disclose the acquisition in the notes to the financial statements.
- d. Disclose the acquisition in the opinion paragraph of the auditor's report.

N86#35. The least likely use by the auditor of generalized audit software is to

- a. Perform analytical review on the client's data.
- b. Access the information stored on the client's EDP files.
- c. Identify weaknesses in the client's EDP controls.
- d. Test the accuracy of the client's computations.

N86#36. Processing simulated file data provides the auditor with information about the reliability of controls from evidence that exists in simulated files. One of the techniques involved in this approach makes use of

- a. Controlled reprocessing.
- b. Program code checking.
- c. Printout reviews.
- d. Integrated test facility.

N86#37. Which of the following sampling plans would be designed to estimate a numerical measurement of a population, such as a dollar value?

- a. Discovery sampling.
- b. Numerical sampling.
- c. Sampling for variables.
- d. Sampling for attributes.

N86#40. An auditor issued an audit report that was dual dated for a subsequent event occurring after the completion of field work but before issuance of the auditor's report. The auditor's responsibility for events occurring subsequent to the completion of field work was

- a. Limited to the specific event referenced.
- b. Limited to include only events occurring before the date of the last subsequent event referenced.
- c. Extended to subsequent events occurring through the date of issuance of the report.
- d. Extended to include all events occurring since the completion of field work.

Auditing

N86#44. Auditors who prefer statistical sampling to nonstatistical sampling may do so because statistical sampling helps the auditor

- a. Measure the sufficiency of the evidential matter obtained.
- b. Eliminate subjectivity in the evaluation of sampling results.
- c. Reduce the level of tolerable error to a relatively low amount.
- d. Minimize the failure to detect a material misstatement due to nonsampling risk.

M86#9. An auditor would be most likely to consider expressing a qualified opinion if the client's financial statements include a footnote on related party transactions that

- a. Lists the amounts due from related parties including the terms and manner of settlement.
- b. Discloses compensating balance arrangements maintained for the benefit of related parties.
- c. Represents that certain transactions with related parties were consummated on terms equally as favorable as would have been obtained in transactions with unrelated parties.
- d. Presents the dollar volume of related party transactions and the effects of any change in the method of establishing terms from that of the prior period.

M86#43. An auditor is concerned with completing various phases of the examination after the balance-sheet date. This "subsequent period" extends to the date of the

- a. Auditor's report.
- b. Final review of the audit working papers.
- c. Public issuance of the financial statements.
- d. Delivery of the auditor's report to the client.

M86#44. A primary advantage of using generalized audit software packages in auditing the financial statements of a client that uses an EDP system is that the auditor may

- a. Substantiate the accuracy of data through self-checking digits and hash totals.
- b. Access information stored on computer files without a complete understanding of the client's hardware and software features.
- c. Reduce the level of required compliance testing to a relatively small amount.
- d. Gather and permanently store large quantities of supportive evidential matter in machine readable form.

M86#54. Which of the following audit procedures would an auditor be *least* likely to perform using a generalized computer audit program?

- a. Searching records of accounts receivable balances for credit balances.

- b. Investigating inventory balances for possible obsolescence.
- c. Selecting accounts receivable for positive and negative confirmation.
- d. Listing of unusually large inventory balances.

N85

Items 21 through 26* are based on the following information:

Hickory, Inc., is a small manufacturer. Its office building, plant, and warehouse are all located in Zena, Ohio. William Cream is the principal owner and president of Hickory.

Hickory is not a publicly held corporation. The primary uses of the financial statements are for its 15 shareholders and for bank credit purposes. Hickory's financial statements have never been audited or reviewed.

On July 18, 1984, William Cream hired the CPA firm of Part & Co. to audit Hickory's financial statements for the year ended December 31, 1984. Part & Co. performed the audit field work from December 15, 1984, through March 10, 1985.

Part & Co. has offices in Cleveland, the office that performed the Hickory audit, and Chicago.

25. Which of the following subsequent events occurring between January 1, 1985, and March 10, 1985, would cause Hickory to adjust its 1984 financial statements?

- a. Short-term investments' aggregate market value declined substantially below cost.
- b. Hickory sold its accounts receivable to a local financial institution.
- c. Hickory issued common stock, to settle a current liability that existed as of the balance sheet date.
- d. William Cream sold all of his common stock in Hickory to Hickory.

N85#31. The most important function of generalized audit software is the capability to

- a. Access information stored on computer files.
- b. Select a sample of items for testing.
- c. Evaluate sample test results.
- d. Test the accuracy of the client's calculations.

N85#40. The existence of a related party transaction may be indicated when another entity

- a. Sells real estate to the corporation at a price that is comparable to its appraised value.
- b. Absorbs expenses of the corporation.
- c. Borrows from the corporation at a rate of interest which equals the current market rate.
- d. Lends to the corporation at a rate of interest which equals the current market rate.

*The items omitted can be found in other Content Specification Groups.

Selected Questions

N85#46. To determine the number of items to be selected in a sample for a particular substantive test of details, the auditor should consider all of the following **except**

- a. Tolerable error.
- b. Deviation rate.
- c. Allowable risk of incorrect acceptance.
- d. Characteristics of the population.

N85#48. The size of a sample designed for dual purpose testing should be

- a. The larger of the samples that would otherwise have been designed for the two separate purposes.
- b. The smaller of the samples that would otherwise have been designed for the two separate purposes.
- c. The combined total of the samples that would otherwise have been designed for the two separate purposes.
- d. More than the larger of the samples that would otherwise have been designed for the two separate purposes, but less than the combined total of the samples that would otherwise have been designed for the two separate purposes.

N85#50. A primary purpose of an operational audit is to provide

- a. The results of internal examinations of financial and accounting matters to a company's top-level management.
- b. A measure of management performance in meeting organizational goals.
- c. A means of assurance that internal accounting controls are functioning as planned.
- d. Aid to the independent auditor, who is conducting the examination of the financial statements.

N85#51. When auditing "around" the computer, the independent auditor focuses solely upon the source documents and

- a. Test data.
- b. EDP processing.
- c. Compliance techniques.
- d. EDP output.

N85#52. What type of EDP system is characterized by data that are assembled from more than one location and records that are updated immediately?

- a. Microcomputer system.
- b. Minicomputer system.
- c. Batch processing system.
- d. Online real-time system.

N85#57. The independent auditors for Louis, Inc., a publicly held company, conclude that their omission of an audit procedure considered necessary at the time of the examination impairs their present ability to support the previously expressed opinion. If they believe there are persons currently relying on the report, they should promptly

- a. Undertake to apply the omitted procedure or alternate procedures that would provide a satisfactory basis for the opinion.
- b. Notify the board of directors that the previously expressed opinion is not to be relied upon.
- c. Notify the stockholders currently relying on the report that the previously expressed opinion is not to be relied upon.
- d. Notify the Securities and Exchange Commission that the previously expressed opinion is not to be relied upon.

M85#1. Smith Corporation has numerous customers. A customer file is kept on disk storage. Each customer file contains name, address, credit limit, and account balance. The auditor wishes to test this file to determine whether credit limits are being exceeded. The best procedure for the auditor to follow would be to

- a. Develop test data that would cause some account balances to exceed the credit limit and determine if the system properly detects such situations.
- b. Develop a program to compare credit limits with account balances and print out the details of any account with a balance exceeding its credit limit.
- c. Request a printout of all account balances so they can be manually checked against the credit limits.
- d. Request a printout of a sample of account balances so they can be individually checked against the credit limits.

M85#31. When an auditor tests a computerized accounting system, which of the following is true of the test data approach?

- a. Test data are processed by the client's computer programs under the auditor's control.
- b. Test data must consist of all possible valid and invalid conditions.
- c. Testing a program at year-end provides assurance that the client's processing was accurate for the full year.
- d. Several transactions of each type must be tested.

D. Review and Compilation Procedures

M89#45. One of the conditions required for an accountant to submit a written personal financial plan containing unaudited financial statements to a client

Auditing

without complying with the requirements of SSARS 1 (Compilation and Review of Financial Statements) is that the

- a. Client agrees that the financial statements will **not** be used to obtain credit.
- b. Accountant compiled or reviewed the client's financial statements for the immediate prior year.
- c. Engagement letter acknowledges that the financial statements will contain departures from generally accepted accounting principles.
- d. Accountant expresses limited assurance that the financial statements are free of any material misstatements.

N88#50. During a compilation of a nonpublic entity's financial statements, an accountant would be **least** likely to

- a. Omit substantially all of the disclosures required by generally accepted accounting principles.
- b. Issue a compilation report on one or more, but **not** all of the basic financial statements.
- c. Perform analytical procedures designed to identify relationships that appear to be unusual.
- d. Read the compiled financial statements and consider whether they appear to include adequate disclosure.

M88#30. When providing limited assurance that the financial statements of a nonpublic entity require **no** material modifications to be in accordance with generally accepted accounting principles, the accountant should

- a. Understand the system of internal accounting control that the entity uses.
- b. Test the accounting records that identify inconsistencies with the prior year's financial statements.
- c. Understand the accounting principles of the industry in which the entity operates.
- d. Develop audit programs to determine whether the entity's financial statements are fairly presented.

M88#40. Which of the following procedures is **not** usually performed by the accountant in a review engagement of a nonpublic entity?

- a. Communicating any material weaknesses discovered during the study and evaluation of internal accounting control.
- b. Reading the financial statements to consider whether they conform with generally accepted accounting principles.
- c. Writing an engagement letter to establish an understanding regarding the services to be performed.
- d. Issuing a report stating that the review was performed in accordance with standards established by the AICPA.

N87#41. Inquiry and analytical procedures ordinarily performed during a review of a nonpublic entity's financial statements include

- a. Analytical procedures designed to identify material weaknesses in internal accounting control.
- b. Inquiries concerning actions taken at meetings of the stockholders and the board of directors.
- c. Analytical procedures designed to test the accounting records by obtaining corroborating evidential matter.
- d. Inquiries of knowledgeable outside parties such as the client's attorneys and bankers.

M87#34. Prior to commencing the compilation of financial statements of a nonpublic entity, the accountant should

- a. Perform analytical review procedures sufficient to determine whether fluctuations among account balances appear reasonable.
- b. Complete the preliminary phase of the study and evaluation of the entity's internal accounting control.
- c. Verify that the financial information supplied by the entity agrees with the books of original entry.
- d. Acquire a knowledge of any specialized accounting principles and practices used in the entity's industry.

M87#35. Which of the following would the accountant most likely investigate during the review of financial statements of a nonpublic entity if accounts receivable did **not** conform to a predictable pattern during the year?

- a. Sales returns and allowances.
- b. Credit sales.
- c. Sales of consigned goods.
- d. Cash sales.

N86#26. Which of the following procedures is usually included in a review engagement of a nonpublic entity?

- a. The confirmation of accounts receivable.
- b. A study and evaluation of internal accounting control.
- c. An inquiry concerning subsequent events.
- d. The observation of physical inventory counts.

N86#42. Before performing a compilation of the financial statements of a nonpublic entity, an accountant should

- a. Perform a thorough study and evaluation of the internal accounting control system.
- b. Complete a series of inquiries concerning the entity's procedures for recording, classifying, and summarizing transactions.
- c. Design working papers intended to provide sufficient competent evidential matter to afford a reasonable basis for a compilation opinion.
- d. Obtain an understanding of the accounting principles and practices of the industry in which the entity operates.

Selected Questions

IV. Reporting

In April 1988, the Auditing Standards Board issued *Statement on Auditing Standards No. 58, "Reports on Audited Financial Statements,"* superseding SAS No. 2, *"Reports on Audited Financial Statements"* (1974). Accordingly, all previous examination items covered by SAS No. 2 have been deleted.

A. Reporting Standards and Types of Reports

M89#46. A limitation on the scope of an auditor's examination sufficient to preclude an unqualified opinion will always result when management

- Engages the auditor after the year-end physical inventory count is completed.
- Fails to correct a material internal control weakness that had been identified during the prior year's audit.
- Refuses to furnish a management representation letter to the auditor.
- Prevents the auditor from reviewing the working papers of the predecessor auditor.

M89#47. An accountant has been asked to compile the financial statements of a nonpublic company on a prescribed form that omits substantially all the disclosures required by generally accepted accounting principles. If the prescribed form is a standard preprinted form adopted by the company's industry trade association, and is to be transmitted only to such association, the accountant

- Need **not** advise the industry trade association of the omission of all disclosures.
- Should disclose the details of the omissions in separate paragraphs of the compilation report.
- Is precluded from issuing a compilation report when all disclosures are omitted.
- Should express limited assurance that the financial statements are free of material misstatements.

M89#48. On September 30, 1988, Miller was asked to reissue an auditor's report, dated March 31, 1988, on a client's financial statements for the year ended December 31, 1987. Miller will submit the reissued report to the client in a document that contains information in addition to the client's basic financial statements. However, Miller discovered that the client suffered substantial losses on receivables resulting from conditions that occurred since March 31, 1988. Miller should

- Request the client to disclose the event in a separate, appropriately labeled note to the financial statements and reissue the original report with its original date.
- Request the client to restate the financial statements and reissue the original report with a dual date.
- Reissue the original report with its original date without regard to whether the event is disclosed in a separate note to the financial statements.
- Not reissue the original report but issue a "subject to" qualified opinion that discloses the event in a separate explanatory paragraph.

M89#49. An auditor who qualifies an opinion because of an insufficiency of evidential matter should describe the limitation in an explanatory paragraph. The auditor should also refer to the limitation in the

	<u>Scope paragraph</u>	<u>Opinion paragraph</u>	<u>Notes to the financial statements</u>
a.	Yes	No	Yes
b.	No	Yes	No
c.	Yes	Yes	No
d.	Yes	Yes	Yes

M89#50. An auditor who conducts an examination in accordance with generally accepted auditing standards and concludes that the financial statements are fairly presented in accordance with a comprehensive basis of accounting other than generally accepted accounting principles, such as the cash basis of accounting, should issue a

- Special report.
- Disclaimer of opinion.
- Review report.
- Qualified opinion.

M89#51. An auditor concludes that there is a material inconsistency in the other information in an annual report to shareholders containing audited financial statements. If the auditor concludes that the financial statements do **not** require revision, but the client refuses to revise or eliminate the material inconsistency, the auditor may

- Issue an "except for" qualified opinion after discussing the matter with the client's board of directors.
- Consider the matter closed since the other information is **not** in the audited financial statements.
- Disclaim an opinion on the financial statements after explaining the material inconsistency in a separate explanatory paragraph.
- Revise the auditor's report to include a separate explanatory paragraph describing the material inconsistency.

M89#52. An auditor may **not** issue a qualified opinion when

- A scope limitation prevents the auditor from completing an important audit procedure.
- The auditor's report refers to the work of a specialist.
- An accounting principle at variance with generally accepted accounting principles is used.
- The auditor lacks independence with respect to the audited entity.

Auditing

M89#54. Unaudited financial statements for the prior year presented in comparative form with audited financial statements for the current year should be clearly marked to indicate their status and

- I. The report on the prior period should be reissued to accompany the current period report.
- II. The report on the current period should include as a separate paragraph a description of the responsibility assumed for the prior period's financial statements.
 - a. I only.
 - b. II only.
 - c. Both I and II.
 - d. Either I or II.

M89#55. When a publicly-held company refuses to include in its audited financial statements any of the segment information that the auditor believes is required, the auditor should issue a(an)

- a. Unqualified opinion with a separate explanatory paragraph emphasizing the matter.
- b. "Except for" qualified opinion because of inadequate disclosure.
- c. Adverse opinion because of the lack of conformity with generally accepted accounting principles.
- d. Disclaimer of opinion because of the significant scope limitation.

M89#56. Green Company uses the first-in, first-out method of costing for its international subsidiary's inventory and the last-in, first-out method of costing for its domestic inventory. The different costing methods would cause Green's auditor to issue a report with an

- a. Explanatory paragraph as to consistency.
- b. "Except for" qualified opinion.
- c. Opinion modified as to consistency.
- d. Unqualified opinion.

M89#57. An accountant's standard report on a compilation of a projection should **not** include

- a. A separate paragraph that describes the limitations on the presentation's usefulness.
- b. A statement that a compilation of a projection is limited in scope.
- c. A disclaimer of responsibility to update the report for events occurring after the report's date.
- d. A statement that the accountant expresses only limited assurance that the results may be achieved.

M89#58. An accountant may accept an engagement to apply agreed-upon procedures to prospective financial statements provided that

- a. Distribution of the report is to be restricted to the specified users involved.
- b. The prospective financial statements are also examined.

- c. Responsibility for the adequacy of the procedures performed is taken by the accountant.
- d. Negative assurance is expressed on the prospective financial statements taken as a whole.

M89#59. When a client will **not** permit inquiry of outside legal counsel, the audit report will ordinarily contain a(an)

- a. Disclaimer of opinion.
- b. "Except for" qualified opinion.
- c. "Subject to" qualified opinion.
- d. Unqualified opinion with a separate explanatory paragraph.

N88#16. An auditor's report includes the following statement:

"The financial statements do not present fairly the financial position, results of operations, or cash flows in conformity with generally accepted accounting principles."

This auditor's report was most likely issued in connection with financial statements that are

- a. Inconsistent.
- b. Based on prospective financial information.
- c. Misleading.
- d. Affected by a material uncertainty.

N88#17. An auditor includes a middle paragraph in an otherwise unqualified report to emphasize that the financial statements are not comparable to those of prior years due to a court-ordered divestiture that is already fully explained in the notes to the financial statements. The inclusion of this paragraph

- a. Should be followed by an "except for" consistency modification in the opinion paragraph.
- b. Requires a revision of the opinion paragraph to include the phrase "with the foregoing explanation."
- c. Is **not** appropriate and may confuse the readers or lead them to believe the report was qualified.
- d. Is appropriate and would **not** negate the unqualified opinion.

N88#18. Green, CPA, is requested to render an opinion on the application of accounting principles by an entity that is audited by another CPA. Green may

- a. Not accept such an engagement because to do so would be considered unethical.
- b. Not accept such an engagement because Green would lack the necessary information on which to base an opinion without conducting an audit.

Selected Questions

- c. Accept the engagement but should form an independent opinion without consulting with the continuing CPA.
- d. Accept the engagement but should consult with the continuing CPA to ascertain all the available facts relevant to forming a professional judgment.

N88#19. An auditor may reasonably issue an "except for" qualified opinion for

	<u>Inadequate disclosure</u>	<u>Scope limitation</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N88#20. An auditor may reasonably issue a "subject to" qualified opinion for

	<u>Lack of consistency</u>	<u>Departure from generally accepted accounting principles</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N88#21. An auditor did not examine an entity's financial statements for the preceding year. Inadequate financial records precluded an opinion as to asset and liability balances at the beginning of the current year and the consistent application of generally accepted accounting principles. The auditor should explain the inadequacies in the financial records in

- a. A middle paragraph, the lack of consistency in the opinion paragraph, and express a disclaimer of opinion on the financial statements.
- b. A middle paragraph, the lack of consistency also in the middle paragraph, and express an opinion only on the balance sheet.
- c. The opinion paragraph, the lack of consistency also in the opinion paragraph, and express a disclaimer of opinion on the financial statements.
- d. The opinion paragraph, the lack of consistency also in the opinion paragraph, and express an opinion only on the balance sheet.

N88#22. Each page of a nonpublic entity's financial statements reviewed by an accountant should include the following reference:

- a. See Accountant's Review Report.
- b. Reviewed, No Accountant's Assurance Expressed.
- c. See Accompanying Accountant's Footnotes.
- d. Reviewed, No Material Modifications Required.

N88#24. An accountant may accept an engagement to apply agreed-upon procedures that are **not** sufficient to express an opinion on one or more specified accounts or items of a financial statement provided that

- a. The accountant's report does **not** enumerate the procedures performed.
- b. The financial statements are prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.
- c. Distribution of the accountant's report is restricted.
- d. The accountant is also the entity's continuing auditor.

N88#25. Reports are considered special reports when issued in connection with

- a. Compliance with aspects of regulatory requirements related to audited financial statements.
- b. Pro forma financial presentations designed to demonstrate the effect of hypothetical transactions.
- c. Feasibility studies presented to illustrate an entity's results of operations.
- d. Interim financial information reviewed to determine whether material modifications should be made to conform with generally accepted accounting principles.

N88#26. When an accountant issues to an underwriter a comfort letter containing comments on data that have **not** been audited, the underwriter most likely will receive

- a. Positive assurance on supplementary disclosures.
- b. Negative assurance on capsule information.
- c. A disclaimer on prospective financial statements.
- d. A limited opinion on "pro forma" financial statements.

N88#27. Prospective financial information presented in the format of historical financial statements that omit either gross profit or net income is deemed to be a

- a. Partial presentation.
- b. Projected balance sheet.
- c. Financial forecast.
- d. Financial projection.

N88#58. Compiled financial statements should be accompanied by a report stating all the following **except**

- a. The accountant does **not** express an opinion or any other form of assurance on the financial statements.
- b. A compilation is substantially less in scope than an examination in accordance with generally accepted auditing standards.
- c. The accountant compiled the financial statements in accordance with standards established by the AICPA.
- d. A compilation is limited to presenting in the form of financial statements information that is the representation of management.

Auditing

M88#25. An auditor reporting on comparative financial statements is **not** required to include an explanatory paragraph in the auditor's report if the opinion paragraph is modified because of a(an)

- a. Change in accounting principle.
- b. Scope limitation.
- c. Disclaimer of opinion.
- d. Uncertainty affecting the financial statements.

M88#41. An auditor did not observe a client's taking of beginning physical inventory and was unable to become satisfied about the inventory by means of other auditing procedures. Assuming no other scope limitations or reporting problems, the auditor could issue an unqualified opinion on the current year's financial statements for

- a. The balance sheet only.
- b. The income statement only.
- c. The income and retained earnings statements only.
- d. All of the financial statements.

M88#42. Performing inquiry and analytical procedures is the primary basis for an accountant to issue a (an)

- a. Compilation report on financial statements for a nonpublic entity in its first year of operations.
- b. Review report on comparative financial statements for a nonpublic entity in its second year of operations.
- c. Management advisory report prepared at the request of a client's audit committee.
- d. Internal accounting control report for a governmental agency in accordance with GAO standards.

M88#43. Which of the following representations does an auditor make explicitly and which implicitly when issuing an unqualified opinion?

	<i>Conformity with GAAP</i>	<i>Adequacy of disclosure</i>
a.	Explicitly	Explicitly
b.	Implicitly	Implicitly
c.	Implicitly	Explicitly
d.	Explicitly	Implicitly

M88#44. The fourth standard of reporting requires the auditor's report to contain either an expression of opinion regarding the financial statements taken as a whole or an assertion to the effect that an opinion cannot be expressed. The objective of the fourth standard is to prevent

- a. An auditor from expressing different opinions on each of the basic financial statements.
- b. Restrictions on the scope of the examination, whether imposed by the client or by the inability to obtain evidence.

- c. Misinterpretations regarding the degree of responsibility the auditor is assuming.
- d. An auditor from reporting on one basic financial statement and **not** the others.

M88#45. An auditor's report expresses an unqualified opinion and includes a middle paragraph that emphasizes a matter included in the notes to the financial statements. The auditor's report would be deficient if the middle paragraph states that the entity

- a. Has changed from the completed-contract method to the percentage of completion method of accounting for long-term construction contracts.
- b. Has had a significant subsequent event.
- c. Has accounting reclassifications that enhance the comparability between the current and prior year.
- d. Is a component of a larger business enterprise.

M88#47. For a particular entity's financial statements to be presented fairly in conformity with generally accepted accounting principles, it is **not** required that the principles selected

- a. Be appropriate in the circumstances for the particular entity.
- b. Reflect transactions in a manner that presents the financial statements within a range of acceptable limits.
- c. Present information in the financial statements that is classified and summarized in a reasonable manner.
- d. Be applied on a basis consistent with those followed in the prior year.

M88#48. Which of the following circumstances requires modification of the accountant's report on a review of interim financial information of a publicly held entity?

	<i>An uncertainty</i>	<i>Inadequate disclosure</i>
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

M88#49. An auditor's report issued in connection with which of the following is generally **not** considered to be a special report?

- a. Compliance with aspects of contractual agreements unrelated to audited financial statements.
- b. Specified elements, accounts, or items of a financial statement presented in a document.
- c. Financial statements prepared in accordance with an entity's income tax basis.
- d. Financial information presented in a prescribed schedule that requires a prescribed form of auditor's report.

Selected Questions

N87#1. An auditor has been asked to report on the balance sheet of Kane Company but not on the other basic financial statements. The auditor will have access to all information underlying the basic financial statements. Under these circumstances, the auditor

- May accept the engagement because such engagements merely involve limited reporting objectives.
- May accept the engagement but should disclaim an opinion because of an inability to apply the procedures considered necessary.
- Should refuse the engagement because there is a client-imposed scope limitation.
- Should refuse the engagement because of a departure from generally accepted auditing standards.

N87#2. When a question arises about an entity's continued existence, the auditor should consider factors tending to mitigate the significance of contrary information concerning the entity's alternative means for maintaining adequate cash flow. An example of such a factor is the

- Possibility of purchasing certain assets rather than leasing them.
- Capability of extending the due dates of existing loans.
- Feasibility of operating at increased levels of production.
- Marketability of property and equipment that management plans to keep.

N87#4. The objective of auditing procedures applied to segment information is to provide the auditor with a reasonable basis for concluding whether

- The information is useful for comparing a segment of one enterprise with a similar segment of another enterprise.
- Sufficient evidential matter has been obtained to allow the auditor to be associated with the segment information.
- A separate opinion on the segment information is necessary due to inconsistent application of accounting principles.
- The information is presented in conformity with the FASB Statement on segment information in relation to the financial statements taken as a whole.

N87#5. The prior year's financial statements of YZ, Inc., which were audited by Pate, CPA, are presented for comparative purposes without Pate's audit report. Jennings, CPA, the successor auditor, should indicate in the current year audit report that the prior year's financial statements were examined by another auditor

- Only if Pate's opinion was other than unqualified.
- But should **not** indicate the type of opinion expressed by Pate.
- Only if the prior year's financial statements have been restated.
- But should **not** name Pate as the predecessor auditor.

N87#7. Financial statements compiled without audit or review by an accountant should be accompanied by a report stating that

- The financial statements have **not** been audited or reviewed and, accordingly, the accountant expresses only limited assurance on them.
- A compilation is limited to presenting in the form of financial statements information that is the representation of management.
- The accountant is **not** aware of any material modifications that should be made to the financial statements for them to conform with generally accepted accounting principles.
- A compilation is less in scope than a review, and substantially less in scope than an examination in accordance with generally accepted auditing standards.

N87#8. If the auditor believes that financial statements prepared on the entity's income tax basis are **not** suitably titled, the auditor should

- Issue a disclaimer of opinion.
- Explain in the notes to the financial statements the terminology used.
- Issue a compilation report.
- Modify the auditor's report to disclose any reservations.

N87#9. An auditor's report on financial statements prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles should include all of the following **except**

- Reference to the note to the financial statements that describes how the basis of preparation differs from generally accepted accounting principles.
- Disclosure of the fact that the financial statements are **not** intended to be presented in conformity with generally accepted accounting principles.
- An opinion as to whether the basis of accounting used is appropriate under the circumstances.
- An opinion as to whether the financial statements are presented fairly in conformity with the basis of accounting described.

N87#11. Which of the following is a prospective financial statement for general use upon which an accountant may appropriately report?

- Financial projection.
- Partial presentation.
- Pro forma financial statement.
- Financial forecast.

N87#12. The party responsible for assumptions identified in the preparation of prospective financial statements is usually

- A third-party lending institution.
- The client's management.
- The reporting accountant.
- The client's independent auditor.

Auditing

N87#13. In which of the following reports should an accountant **not** express negative or limited assurance?

- a. A standard review report on financial statements of a nonpublic entity.
- b. A standard compilation report on financial statements of a nonpublic entity.
- c. A standard comfort letter on financial information included in a registration statement of a public entity.
- d. A standard review report on interim financial statements of a public entity.

N87#40. An accountant has been asked to issue a review report on the balance sheet of a nonpublic company but not to report on the other basic financial statements. The accountant may **not** do so

- a. Because compliance with this request would result in an incomplete review.
- b. Because compliance with this request would result in a violation of the ethical standards of the profession.
- c. If the scope of the inquiry and analytical procedures has been restricted.
- d. If the review of the balance sheet discloses material departures from generally accepted accounting principles.

M87#42. If the financial statements, including accompanying notes, fail to disclose information that is required by generally accepted accounting principles, the auditor should express either a(an)

- a. "Except for" qualified opinion or an adverse opinion.
- b. Adverse opinion or a "subject to" qualified opinion.
- c. "Subject to" qualified opinion or an unqualified opinion with a separate explanatory paragraph.
- d. Unqualified opinion with a separate explanatory paragraph or an "except for" qualified opinion.

M87#51. The management of a client company believes that the statement of changes in financial position (statement of cash flows) is not a useful document and refuses to include one in the annual report to stockholders. As a result of this circumstance, the auditor's opinion should be

- a. Adverse.
- b. Unqualified.
- c. Qualified due to inadequate disclosure.
- d. Qualified due to a scope limitation.

M87#53. The auditor would most likely issue a disclaimer of opinion because of

- a. The client's failure to present supplementary information required by the FASB.
- b. Inadequate disclosure of material information.
- c. A client-imposed scope limitation.
- d. The qualification of an opinion by the other auditor of a subsidiary where there is a division of responsibility.

M87#54. When reporting on comparative financial statements where the financial statements of the prior period have been examined by a predecessor auditor whose report is **not** presented, the successor auditor should indicate in the scope paragraph

- a. The reasons why the predecessor auditor's report is **not** presented.
- b. The identity of the predecessor auditor who examined the financial statements of the prior year.
- c. Whether the predecessor auditor's review of the current year's financial statements revealed any matters that might have a material effect on the successor auditor's opinion.
- d. The type of opinion expressed by the predecessor auditor.

M87#55. When an auditor reports on financial statements prepared on an entity's income tax basis, the auditor's report should

- a. Disclose that the statements are **not** intended to conform with generally accepted accounting principles.
- b. Disclaim an opinion on whether the statements were examined in accordance with generally accepted auditing standards.
- c. **Not** express an opinion on whether the statements are presented in conformity with the comprehensive basis of accounting used.
- d. Include an explanation of how the results of operations differ from the cash receipts and disbursements basis of accounting.

M87#57. Given one or more hypothetical assumptions, a responsible party may prepare, to the best of its knowledge and belief, an entity's expected financial position, results of operations, and changes in financial position. Such prospective financial statements are known as

- a. Pro forma financial statements.
- b. Financial projections.
- c. Partial presentations.
- d. Financial forecasts.

M87#58. Which of the following are prospective financial statements upon which an accountant may appropriately report for general use?

- a. Pro forma financial statements.
- b. Financial projections.
- c. Partial presentations.
- d. Financial forecasts.

M87#60. If an auditor believes there is minimal likelihood that resolution of an uncertainty will have a material effect on the financial statements, the auditor should issue a(an)

- a. Unqualified opinion.
- b. Disclaimer of opinion.
- c. "Except for" qualified opinion.
- d. "Subject to" qualified opinion.

Selected Questions

N86#45. Management of Blue Company has decided not to account for a material transaction in accordance with the provisions of an FASB Standard. In setting forth its reasons in a note to the financial statements, management has clearly demonstrated that due to unusual circumstances the financial statements presented in accordance with the FASB Standard would be misleading. The auditor's report should include an explanatory separate paragraph and contain a(an)

- a. Adverse opinion.
- b. Unqualified opinion.
- c. "Except for" qualified opinion.
- d. "Subject to" qualified opinion.

N86#48. When the financial statements contain a departure from generally accepted accounting principles, the effect of which is material, the auditor should

- a. Qualify the opinion and explain the effect of the departure from generally accepted accounting principles in a separate paragraph.
- b. Qualify the opinion and describe the departure from generally accepted accounting principles within the opinion paragraph.
- c. Disclaim an opinion and explain the effect of the departure from generally accepted accounting principles in a separate paragraph.
- d. Disclaim an opinion and describe the departure from generally accepted accounting principles within the opinion paragraph.

N86#49. Which of the following should be included in an accountant's standard report based upon the review of a nonpublic entity's financial statements?

- a. A statement that the review was performed in accordance with generally accepted review standards.
- b. A statement that a review consists principally of inquiries and analytical procedures.
- c. A statement that the accountant is independent with respect to the entity.
- d. A statement that a review is substantially greater in scope than a compilation.

N86#50. Which of the following should **not** be included in an accountant's standard report based upon the compilation of an entity's financial statements?

- a. A statement that a compilation is limited to presenting in the form of financial statements information that is the representation of management.
- b. A statement that the compilation was performed in accordance with standards established by the American Institute of CPAs.
- c. A statement that the accountant has **not** audited or reviewed the financial statements.
- d. A statement that the accountant does **not** express an opinion but expresses only limited assurance on the financial statements.

N86#51. Under which of the following circumstances would a disclaimer of opinion **not** be appropriate?

- a. The financial statements fail to contain adequate disclosure concerning related party transactions.

- b. The client refuses to permit its attorney to furnish information requested in a letter of audit inquiry.
- c. The auditor is engaged after fiscal year-end and is unable to observe physical inventories or apply alternative procedures to verify their balances.
- d. The auditor is unable to determine the amounts associated with illegal acts committed by the client's management.

N86#52. If an accountant concludes that unaudited financial statements on which the accountant is disclaiming an opinion also lack adequate disclosure, the accountant should suggest appropriate revision. If the client does **not** accept the accountant's suggestion, the accountant should

- a. Issue an adverse opinion and describe the appropriate revision in the report.
- b. Make reference to the appropriate revision and issue a modified report expressing limited assurance.
- c. Describe the appropriate revision to the financial statements in the accountant's disclaimer of opinion.
- d. Accept the client's inaction because the statements are unaudited and the accountant has disclaimed an opinion.

N86#53. When reporting on comparative financial statements where the financial statements of the prior year have been examined by a predecessor auditor whose report is **not** presented, the successor auditor should make

- a. No reference to the predecessor auditor.
- b. Reference to the predecessor auditor only if the predecessor auditor expressed a qualified opinion.
- c. Reference to the predecessor auditor only if the predecessor auditor expressed an unqualified opinion.
- d. Reference to the predecessor auditor regardless of the type of opinion expressed by the predecessor auditor.

N86#56. In which of the following circumstances would an auditor be most likely to express an adverse opinion?

- a. The statements are **not** in conformity with the FASB Statements regarding the capitalization of leases.
- b. Information comes to the auditor's attention that raises substantial doubt about the entity's ability to continue in existence.
- c. The chief executive officer refuses the auditor access to minutes of board of directors' meetings.
- d. Compliance tests show that the entity's system of internal accounting control is so poor that it can **not** be relied upon.

Auditing

N86#57. The objective of a review of interim financial information is to provide the accountant with a basis for reporting whether

- a. A reasonable basis exists for expressing an updated opinion regarding the financial statements that were previously audited.
- b. Material modifications should be made to conform with generally accepted accounting principles.
- c. The financial statements are presented fairly in accordance with standards of interim reporting.
- d. The financial statements are presented fairly in accordance with generally accepted accounting principles.

N86#58. An auditor's report would be designated as a special report when it is issued in connection with financial statements that are

- a. For an interim period and are subjected to a limited review.
- b. Unaudited and are prepared from a client's accounting records.
- c. Prepared in accordance with a comprehensive basis of accounting other than generally accepted accounting principles.
- d. Purported to be in accordance with generally accepted accounting principles but do **not** include a presentation of the statement of changes in financial position.

M86#23. During a review of the financial statements of a nonpublic entity, the CPA finds that the financial statements contain a material departure from generally accepted accounting principles. If management refuses to correct the financial statement presentations, the CPA should

- a. Attach a footnote explaining the effects of the departure.
- b. Disclose the departure in a separate paragraph of the report.
- c. Issue a compilation report.
- d. Issue an adverse opinion.

M86#35. Comparative financial statements include the financial statements of a prior period which were examined by a predecessor auditor whose report is **not** presented. If the predecessor auditor's report was qualified, the successor auditor must

- a. Obtain written approval from the predecessor auditor to include the prior year's financial statements.
- b. Issue a standard comparative audit report indicating the division of responsibility.
- c. Express an opinion on the current year statements alone and make **no** reference to the prior year statements.
- d. Disclose the reasons for any qualification in the predecessor auditor's opinion.

M86#49. The auditor who intends to express a qualified opinion should disclose all the substantive reasons in a separate explanatory paragraph of the report, **except** when the opinion paragraph

- a. Makes reference to a contingent liability.
- b. Describes a limitation on the scope of the examination.
- c. Describes the use of an accounting principle at variance with generally accepted accounting principles.
- d. Makes reference to a change in accounting principle.

M86#50. Which of the following requires recognition in the auditor's opinion as to consistency?

- a. The correction of an error in the prior year's financial statements resulting from a mathematical mistake in capitalizing interest.
- b. The change from the cost method to the equity method of accounting for investments in common stock.
- c. A change in the estimate of provisions for warranty costs.
- d. A change in depreciation method which has **no** effect on current year's financial statements but is certain to affect future years.

M86#51. An auditor includes a separate paragraph in an otherwise unqualified report to emphasize that the entity being reported upon had significant transactions with related parties. The inclusion of this separate paragraph

- a. Violates generally accepted auditing standards if this information is already disclosed in footnotes to the financial statements.
- b. Necessitates a revision of the opinion paragraph to include the phrase "with the foregoing explanation."
- c. Is appropriate and would **not** negate the unqualified opinion.
- d. Is considered an "except for" qualification of the report.

M86#52. When an independent CPA is associated with the financial statements of a publicly held entity but has **not** audited or reviewed such statements, the appropriate form of report to be issued must include a(an)

- a. Disclaimer of opinion.
- b. Compilation report.
- c. Adverse opinion.
- d. Unaudited association report.

M86#55. A limitation on the scope of the auditor's examination sufficient to preclude an unqualified opinion will always result when management

- a. Asks the auditor to report on the balance sheet and **not** on the other basic financial statements.

Selected Questions

- b. Refuses to permit its lawyer to respond to the letter of audit inquiry.
- c. Discloses material related-party transactions in the footnotes to the financial statements.
- d. Knows that confirmation of accounts receivable is **not** feasible.

N85

Items 21 through 26* are based on the following information:

Hickory, Inc., is a small manufacturer. Its office building, plant, and warehouse are all located in Zena, Ohio. William Cream is the principal owner and president of Hickory.

Hickory is not a publicly-held corporation. The primary uses of the financial statements are for its 15 shareholders and for bank credit purposes. Hickory's financial statements have never been audited or reviewed.

On July 18, 1984, William Cream hired the CPA firm of Part & Co. to audit Hickory's financial statements for the year ended December 31, 1984. Part & Co. performed the audit field work from December 15, 1984, through March 10, 1985.

Part & Co. has offices in Cleveland, the office that performed the Hickory audit, and Chicago.

23. If Part & Co. were able to examine satisfactory evidence for all items in the financial statements **except** verification of Hickory's January 1, 1984, inventory quantities, Part's opinion on Hickory's 1984 financial statements will probably be

- a. A disclaimer for both the balance sheet and income statement.
- b. A disclaimer for the balance sheet and unqualified for the income statement.
- c. Unqualified for the balance sheet and "subject to" for the income statement.
- d. Unqualified for the balance sheet and a disclaimer for the income statement.

24. Hickory will present comparative financial statements for 1983 and 1984. What procedures should Part & Co. adopt relating to the 1983 financial information?

- a. Part should perform sufficient analytical review procedures in order to assure that there are only immaterial differences between 1983 balances and 1984 balances.
- b. Part should perform sufficient procedures in order to assure that accounting principles employed are consistent between 1983 and 1984.
- c. Since the 1983 financial statements are included with the audited 1984 financial statements, Part must perform an examination of the 1983 financial statements in accordance with GAAS.
- d. Since the 1983 financial statements are unaudited, **no** procedures are required.

N85#33. If an auditor has **not** gathered sufficient evidential matter to support the management assertions that are embodied in the financial statements, the auditor may either issue a(an)

- a. Disclaimer of opinion or "except for" qualified opinion.
- b. Adverse opinion or disclaimer of opinion.
- c. Adverse opinion or "except for" qualified opinion.
- d. Disclaimer of opinion or "subject to" qualified opinion.

N85#53. Restrictions imposed by the client, Rex Company, prohibit the confirmation of accounts receivable by direct communication with debtors. These receivables account for 30% of all assets and alternative audit procedures can **not** be applied, although the independent auditor was able to examine satisfactory evidence for all other items in the financial statements. The independent auditor should issue a(an)

- a. Disclaimer of opinion.
- b. Adverse opinion.
- c. "Subject to" qualified opinion.
- d. "Except for" qualified opinion.

N85#54. If an auditor dates the auditor's report on financial statements for the year ended December 31, 1984, as of February 10, 1985, except for Note J, as to which the date is March 3, 1985, the auditor is taking responsibility for

- a. All subsequent events occurring through March 3, 1985.
- b. All subsequent events occurring through February 10, 1985 only.
- c. All subsequent events occurring through February 10, 1985, and the specific subsequent event referred to in Note J through March 3, 1985.
- d. Only the specific subsequent event referred to in Note J through March 3, 1985.

N85#58. The report of a CPA on a review of the financial statements of a nonpublic entity should **not** include a statement that

- a. All information included in the financial statements is the representation of the owners of the entity.
- b. The review was performed in accordance with generally accepted auditing standards.
- c. The CPA is **not** aware of any material modifications that should be made to the financial statements in order for them to be in conformity with generally accepted accounting principles.
- d. A review consists principally of inquiries of company personnel and analytical procedures applied to financial data.

*The items omitted can be found in other Content Specification Groups.

Auditing

M85#4. In which of the following reports should a CPA **not** express negative or limited assurance?

- a. A standard compilation report on financial statements of a nonpublic entity.
- b. A standard review report on financial statements of a nonpublic entity.
- c. A standard review report on interim financial statements of a public entity.
- d. A standard comfort letter on financial information included in a registration statement of a public entity.

M85#15. When reporting on financial statements prepared on a comprehensive basis of accounting other than generally accepted accounting principles, the independent auditor should include in the report a paragraph that

- a. States that the financial statements are **not** intended to be in conformity with generally accepted accounting principles.
- b. States that the financial statements are **not** intended to have been examined in accordance with generally accepted auditing standards.
- c. Refers to the authoritative pronouncements that explain the comprehensive basis of accounting being used.
- d. Justifies the comprehensive basis of accounting being used.

M85#32. Doe, an independent auditor, was engaged to perform an examination of the financial statements of Ally Incorporated one month after its fiscal year had ended. Although the inventory count was not observed by Doe, and accounts receivable were not confirmed by direct communication with debtors, Doe was able to gain satisfaction by applying alternative auditing procedures. Doe's auditor's report will probably contain

- a. A standard unqualified opinion.
- b. An unqualified opinion and an explanatory middle paragraph.
- c. Either a qualified opinion or a disclaimer of opinion.
- d. An "except for" qualification.

M85#36. When financial statements are presented that are **not** in conformity with generally accepted accounting principles an auditor may issue a(an)

	<u>"Except for"</u> <u>opinion</u>	<u>Disclaimer</u> <u>of an opinion</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

M85#37. Inquiry of the entity's personnel and analytical procedures are the primary bases for the issuance of a(an)

- a. Compilation report on financial statements for a nonpublic company in its first year of operations.

- b. Auditor's report on financial statements supplemented with price level information.
- c. Review report on comparative financial statements for a nonpublic company in its second year of operations.
- d. Management advisory report prepared at the request of the client's audit committee.

M85#45. An auditor would issue an adverse opinion if

- a. The audit was begun by other independent auditors who withdrew from the engagement.
- b. A qualified opinion can **not** be given because the auditor lacks independence.
- c. The restriction on the scope of the audit was significant.
- d. The statements taken as a whole do **not** fairly present the financial condition and results of operations of the company.

B. Other Reporting Considerations

M89#53. Comfort letters ordinarily are addressed to

- a. The Securities and Exchange Commission.
- b. Underwriters of securities.
- c. Creditor financial institutions.
- d. The client's audit committee.

M89#60. An auditor may issue the standard audit report when the

- a. Auditor refers to the findings of a specialist.
- b. Financial statements are derived and condensed from complete audited financial statements that are filed with a regulatory agency.
- c. Financial statements are prepared on the cash receipts and disbursements basis of accounting.
- d. Principal auditor assumes responsibility for the work of another auditor.

N88#14. The Securities and Exchange Commission has authority to

- a. Prescribe specific auditing procedures to detect fraud concerning inventories and accounts receivable of companies engaged in interstate commerce.
- b. Deny lack of privity as a defense in third-party actions for gross negligence against the auditors of public companies.
- c. Determine accounting principles for the purpose of financial reporting by companies offering securities to the public.
- d. Require a change of auditors of governmental entities after a given period of years as a means of ensuring auditor independence.

N88#28. After an audit report containing an unqualified opinion on a non-public client's financial statements was issued, the client decided to sell the shares

Selected Questions

of a subsidiary that accounts for 30% of its revenue and 25% of its net income. The auditor should

- a. Determine whether the information is reliable and, if determined to be reliable, request that revised financial statements be issued.
- b. Notify the entity that the auditor's report may **no** longer be associated with the financial statements.
- c. Describe the effects of this subsequently discovered information in a communication with persons known to be relying on the financial statements.
- d. Take **no** action because the auditor has **no** obligation to make any further inquiries.

N88#29. The principal auditor is satisfied with the independence and professional reputation of the other auditor who has audited the financial statements of a subsidiary. To indicate the division of responsibility, the principal auditor should modify

- a. Only the opinion paragraph of the report.
- b. Only the opinion paragraph of the report and include an explanatory middle paragraph.
- c. Only the scope paragraph of the report.
- d. Both the scope and opinion paragraphs of the report.

M88#50. Information accompanying the basic financial statements in an auditor-submitted document should **not** include

- a. An analysis of inventory by location.
- b. A statement that the allowance for doubtful accounts is adequate.
- c. A statement that the depreciable life of a new asset is 20 years.
- d. An analysis of revenue by product line.

N87#15. Which of the following statements is correct regarding the auditor's responsibilities for supplementary information required by the FASB?

- a. Because the supplementary information is a required part of the basic financial statements, the auditor should apply normal auditing procedures.
- b. The omission of, but **not** deficiencies in, supplementary information should be disclosed in the opinion paragraph of the auditor's report.
- c. Because the supplementary information is **not** a required part of the basic financial statements, the auditor should apply only certain limited procedures.
- d. The omission of supplementary information ordinarily requires the auditor to issue an adverse opinion, but mere deficiencies require an "except for" qualified opinion.

N87#30. The underwriter of a securities offering may request that an auditor perform specified procedures and supply certain assurances concerning unaudited in-

formation contained in a registration statement. The auditor's response to such a request is commonly called a

- a. Report under federal security statutes.
- b. Comfort letter.
- c. Review of interim financial information.
- d. Compilation report for underwriters.

N87#60. When audited financial statements are presented in a document containing other information, the auditor

- a. Has an obligation to perform auditing procedures to corroborate the other information.
- b. Is required to issue an "except for" qualified opinion if the other information has a material misstatement of fact.
- c. Should read the other information to consider whether it is inconsistent with the audited financial statements.
- d. Has **no** responsibility for the other information because it is **not** part of the basic financial statements.

M87#49. When an independent accountant's report based on a review of interim financial information is incorporated by reference in a registration statement, the Securities and Exchange Commission requires that the prospectus clarify that the accountant's report is **not**

- a. A part of the registration statement within the meaning of the Securities Act of 1933.
- b. Subject to the Statements on Standards for Accounting and Review Services.
- c. To be relied upon due to the limited nature of the procedures applied.
- d. Included in the company's quarterly report on Form 10-Q.

M87#56. Subsequent to the issuance of the auditor's report, the auditor became aware of facts existing at the report date that would have affected the report had the auditor then been aware of such facts. After determining that the information is reliable, the auditor should next

- a. Notify the board of directors that the auditor's report must **no** longer be associated with the financial statements.
- b. Determine whether there are persons relying or likely to rely on the financial statements who would attach importance to the information.
- c. Request that management disclose the effects of the newly discovered information by adding a footnote to subsequently issued financial statements.
- d. Issue revised pro forma financial statements taking into consideration the newly discovered information.

Auditing

M87#59. Which of the following best describes the auditor's reporting responsibility concerning information accompanying the basic financial statements in an auditor-submitted document?

- a. The auditor should report on all the information included in the document.
- b. The auditor should report on the basic financial statements but may **not** issue a report covering the accompanying information.
- c. The auditor should report on the information accompanying the basic financial statements only if the auditor participated in the preparation of the accompanying information.
- d. The auditor should report on the information accompanying the basic financial statements only if the document is being distributed to public shareholders.

N86#55. When an auditor reissues in 1986 the auditor's report on the 1983 financial statements at the request of the client without revising the 1983 wording, the auditor should

- a. Use the date of the original report.
- b. Use the date of the client's request.
- c. Use the date of the current period report.
- d. Dual date the report.

N86#59. If a publicly held entity declines to include in its financial report supplementary information required by the FASB, the auditor should issue

- a. An unqualified opinion with a separate explanatory paragraph.
- b. Either a disclaimer of opinion or an adverse opinion.
- c. Either an "except for" qualified opinion or a disclaimer of opinion.
- d. Either an adverse opinion or an "except for" qualified opinion.

N86#60. Comfort letters are ordinarily signed by the

- a. Client.
- b. Client's lawyer.
- c. Independent auditor.
- d. Internal auditor.

M86#8. After issuance of the auditor's report, the auditor has **no** obligation to make any further inquiries with respect to audited financial statements covered by that report unless

- a. A final resolution of a contingency that had resulted in a qualification of the auditor's report is made.

- b. A development occurs that may affect the client's ability to continue as a going concern.
- c. An investigation of the auditor's practice by a peer review committee ensues.
- d. New information is discovered concerning undisclosed related party transactions of the previously audited period.

M85#14. When auditing a public entity's financial statements that include segment information, the auditor should

- a. Make certain the segment information is labeled unaudited and determine that the information is consistent with audited information.
- b. Make certain the segment information is labeled unaudited and perform only analytical review procedures on the segment information.
- c. Audit the segment information and, if the information is adequate and in conformity with GAAP, do **not** make reference to the segment information in the auditor's report.
- d. Audit the segment information and, if the information is adequate and in conformity with GAAP, refer to the segment information in the auditor's report.

M85#42. If management chooses to place supplementary information required by the FASB in footnotes attached to the financial statements, this information should be clearly marked as

- a. Unaudited.
- b. Supplementary information required by the FASB.
- c. Disclosures required by the FASB.
- d. Audited financial data required by generally accepted accounting principles.

M85#55. When an independent audit report is incorporated by reference in an SEC registration statement, a prospectus that includes a statement about the independent accountant's involvement should refer to the independent accountant as

- a. Auditor of the financial reports.
- b. Management's designate before the SEC.
- c. Certified preparer of the report.
- d. Expert in auditing and accounting.

SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. Professional Responsibilities

A. General Standards and Code of Professional Conduct

M89# 2 c
M89# 3 a
M89#26 a
N88# 1 c
N88# 2 d
N88# 3 a
N88# 4 a
N88# 5 c
M88#51 c
M88#52 a
M88#53 d
N87# 17 c
N87# 18 b
N87# 19 a
N87# 22 c
M87# 1 c
M87#29 b
N86# 1 b
N86# 4 b
N86# 6 a
N86# 12 d
M86# 6 c

M86#16 a
M86#17 d
M86#18 b
M86#19 d
M86#22 c
N85# 1 c
N85# 2 c
N85# 4 b
N85# 7 d
N85# 13 c
N85# 14 a
N85# 26 b
M85#17 c
M85#28 c
M85#48 a

M88#55 b
M88#56 c
M88#57 d
N87# 20 c
N87# 23 d
N87# 26 d
N87# 27 a
N87# 49 b
N86# 7 a
N86# 8 d
N86# 9 c
N86# 10 d
M86# 4 a
M86#20 a
M86#26 b
N85# 3 d
N85# 10 b
M85# 3 d
M85#18 a
M85#49 a

N88# 30 c
M88#58 a
M88#59 b
M88#60 c
N87# 10 a
N87# 24 d
N87# 25 c
N87# 28 b
N87# 29 a
M87# 5 c
M87# 6 b
N86# 3 b
N86# 14 a
N86# 15 d
N86# 16 c
M86#10 b
M86#27 a
M86#28 a
M86#37 a
N85# 5 d
N85# 6 a
N85# 8 d
N85# 12 a
M85# 2 a
M85#19 b
M85#20 b
M85#59 d

B. Control of the Audit

M89# 4 c
M89# 5 d
N88# 6 a
N88# 7 d
N88# 11 b
N88# 23 b
N88# 33 b
M88#54 d

C. Other Responsibilities

N88# 9 b
N88# 10 d
N88# 12 a
N88# 15 c

II. Internal Control

A. Definitions and Basic Concepts

M89# 6 d
M89# 7 c
N88# 31 b
N88# 32 b
N88# 36 a
M88# 2 d
N87# 42 d
M87# 2 d
N86# 13 c
N86# 18 d
M86#12 c
M86#31 c
N85# 37 a
M85# 5 b
M85# 7 b
M85#22 c

B. Consideration of the Internal Control Structure

M85#25 b
M85#26 c
M89# 8 d
M89# 9 b
M89#10 c
M89#11 a
M89#12 b
M89#13 b
N88# 34 a
N88# 38 b
N88# 39 c
N88# 49 b
M88# 3 c
M88# 6 b

M88# 7 c
M88# 8 d
N87# 39 b
M87# 7 c
M87# 8 c
M87#11 d
M86#13 c
M86#14 c
M86#25 d
M86#30 d
M85#30 c
M85#51 b
M85#52 b

C. Cycles

M89#14 c
M89#15 a
M89#16 c

M89#17 d
M89#18 b
M89#19 c
N88# 40 b
N88# 41 a
N88# 42 a
N88# 43 b
N88# 44 c
N88# 45 d
N88# 46 a
M88# 5 a
M88# 9 b
M88#10 a
M88#11 d
M88#13 a
M88#20 b
N87# 47 d
N87# 48 d

Auditing

N87# 50 a	M86# 1 b	D. Other Considerations	N87# 52 b
N87# 53 d	M86#38 c	M89#20 d	N87# 57 a
N87# 54 b	M86#39 c	M89#21 b	N87# 58 d
N87# 55 a	M86#45 a	M89#22 a	N87# 59 d
N87# 56 b	M86#58 b	M89#23 c	M87#19 c
M87#12 c	N85# 19 c	M89#24 a	M87#24 b
M87#13 b	N85# 20 a	M89#25 b	M87#25 c
M87#14 b	N85# 27 c	N88# 35 d	M87#26 d
M87#15 d	N85# 28 c	N88# 47 c	N86# 20 d
M87#16 a	N85# 34 c	N88# 48 c	M86#47 a
M87#17 b	M85# 9 a	N88# 60 b	N85# 29 c
M87#20 c	M85#24 b	M88#15 d	N85# 30 b
M87#21 d	M85#38 c	M88#16 c	N85# 60 d
N86# 22 b	M85#40 a	N87# 16 b	M85#23 c
N86# 23 b	M85#53 b	N87# 51 c	M85#35 b
N86# 24 c	M85#60 b		M85#54 b

III. Evidence and Procedures

A. Audit Evidence	M86# 2 c	M87#38 b	M87#45 a
M89# 1 a	M86# 5 d	M87#43 c	M87#47 a
M89#27 c	M86#33 b	N86# 38 d	M87#48 c
M89#28 a	M86#34 c	N86# 39 d	N86# 35 c
M89#29 a	M86#48 c	N86# 43 c	N86# 36 d
M89#30 c	N85# 22 d	M86#42 d	N86# 37 c
M89#32 b	N85# 35 d	N85# 42 b	N86# 40 a
M89#34 d	N85# 44 a	N85# 43 b	N86# 44 a
N88# 51 d	N85# 45 d	N85# 49 b	M86# 9 c
N88# 52 d	N85# 47 d	M85#29 d	M86#43 a
N88# 53 c	M85#13 c	M85#39 b	M86#44 b
M88#21 a	M85#46 d		M86#54 b
M88#22 b	M85#47 a	C. Other Specific Audit Topics	N85# 25 c
M88#23 c	M85#56 a	M89#38 b	N85# 31 a
M88#24 c	M85#58 b	M89#39 c	N85# 40 b
M88#46 a		M89#40 c	N85# 46 b
N87# 32 a	B. Specific Audit Objectives and Procedures	M89#41 d	N85# 48 a
N87# 33 c	M89#31 a	M89#42 d	N85# 50 b
N87# 34 b	M89#33 d	M89#43 d	N85# 51 d
N87# 35 b	M89#35 b	M89#44 b	N85# 52 d
N87# 36 d	M89#36 b	N88# 8 c	N85# 57 a
M87# 3 d	M89#37 a	N88# 57 a	M85# 1 b
M87#23 d	N88# 54 b	N88# 59 b	M85#31 a
M87#27 c	N88# 55 a	M88#17 b	
M87#28 a	N88# 56 c	M88#31 b	D. Review and Compilation Procedures
M87#30 d	N88# 26 b	M88#33 d	M89#45 a
M87#31 b	M88#27 d	M88#34 a	N88# 50 c
M87#32 a	M88#28 b	M88#35 d	M88#30 c
M87#46 c	M88#29 b	M88#36 d	M88#40 a
N86# 28 a	M88#39 c	M88#37 b	N87# 41 b
N86# 29 b	N87# 31 a	M88#38 d	M87#34 d
N86# 30 d	N87# 37 d	N87# 6 c	M87#35 b
N86# 31 c	M87#36 b	N87# 38 d	N86# 26 c
N86# 32 c	M87#37 c	M87#33 a	N86# 42 d
N86# 34 a		M87#39 a	
N86# 47 a			

Unofficial Answers

IV. Reporting

**A. Reporting Standards
and Types of Reports**

M89#46 c
M89#47 a
M89#48 a
M89#49 c
M89#50 a
M89#51 d
M89#52 d
M89#54 d
M89#55 b
M89#56 d
M89#57 d
M89#58 a
M89#59 a
N88# 16 c
N88# 17 d
N88# 18 d
N88# 19 a
N88# 20 d
N88# 21 b
N88# 22 a
N88# 24 c
N88# 25 a
N88# 26 b

N88# 27 a
N88# 58 b
M88#25 a
M88#41 a
M88#42 b
M88#43 d
M88#44 c
M88#45 a
M88#47 d
M88#48 d
M88#49 a
N87# 1 a
N87# 2 b
N87# 4 d
N87# 5 d
N87# 7 b
N87# 8 d
N87# 9 c
N87# 11 d
N87# 12 b
N87# 13 b
N87# 40 c
M87#42 a
M87#51 c
M87#53 c
M87#54 d
M87#55 a

M87#57 b
M87#58 d
M87#60 a
N86# 45 b
N86# 48 a
N86# 49 b
N86# 50 d
N86# 51 a
N86# 52 c
N86# 53 d
N86# 56 a
N86# 57 b
N86# 58 c
M86#23 b
M86#35 d
M86#49 d
M86#50 b
M86#51 c
M86#52 a
M86#55 b
N85# 23 d
N85# 24 b
N85# 33 a
N85# 53 a
N85# 54 c
N85# 58 b
M85# 4 a

M85#15 a
M85#32 a
M85#36 a
M85#37 c
M85#45 d

**B. Other Reporting
Considerations**

M89#53 b
M89#60 d
N88# 14 c
N88# 28 d
N88# 29 d
M88#50 b
N87# 15 c
N87# 30 b
N87# 60 c
M87#49 a
M87#56 b
M87#59 a
N86# 55 a
N86# 59 a
N86# 60 c
M86# 8 d
M85#14 c
M85#42 a
M85#55 d

ESSAYS — SELECTED QUESTIONS

I. Professional Responsibilities

M89

Number 5 (Estimated time — 15 to 25 minutes)

Reed, CPA, accepted an engagement to audit the financial statements of Smith Company. Reed's discussions with Smith's new management and the predecessor auditor indicated the possibility that Smith's financial statements may be misstated due to the possible occurrence of errors, irregularities, and illegal acts.

Required:

- a. Identify and describe Reed's responsibilities to detect Smith's errors and irregularities. Do not identify specific audit procedures.
- b. Identify and describe Reed's responsibilities to report Smith's errors and irregularities.
- c. Describe Reed's responsibilities to detect Smith's material illegal acts. Do not identify specific audit procedures.
- d. Describe Reed's additional responsibilities to report on errors, irregularities, and illegal acts if this audit were one to which the requirements of *Government Auditing Standards* apply.

M88

Number 2 (Estimated time — 15 to 25 minutes)

An accountant is sometimes called on by clients to report on or assemble prospective financial statements for use by third parties.

Required:

- a. 1. Identify the types of engagements that an accountant may perform under these circumstances.

2. Explain the difference between "general use" of and "limited use" of prospective financial statements.
3. Explain what types of prospective financial statements are appropriate for "general use" and what types are appropriate for "limited use."

M87

Number 5 (Estimated time — 15 to 25 minutes)

Parker is the in-charge auditor with administrative responsibilities for the upcoming annual audit of FGH Company, a continuing audit client. Parker will supervise two assistants on the engagement and will visit the client before the field work begins.

Parker has started the planning process by preparing a list of procedures to be performed prior to the beginning of field work. The list includes:

1. Review correspondence and permanent files.
2. Review prior years' audit working papers, financial statements, and auditor's reports.
3. Discuss with CPA firm personnel responsible for audit and non-audit services to the client, matters that may affect the examination.
4. Discuss with management current business developments affecting the client.

Required:

Complete Parker's list of procedures to be performed prior to the beginning of field work.

II. Internal Control

B. Consideration of the Internal Control Structure

N86

Number 4 (Estimated time — 15 to 25 minutes)

Ajax Inc., an audit client, recently installed a new EDP system to process more efficiently the shipping, billing, and accounts receivable records. During interim

work, an assistant completed the review of the accounting system and the internal accounting controls. The assistant determined the following information concerning the new EDP system and the processing and control of shipping notices and customer invoices.

Each major computerized function, i.e., shipping, billing, accounts receivable, etc., is permanently assigned to a specific computer operator who is respon-

sible for making program changes, running the program, and reconciling the computer log. Responsibility for the custody and control over the magnetic tapes and system documentation is randomly rotated among the computer operators on a monthly basis to prevent any one person from having access to the tapes and documentation at all times. Each computer programmer and computer operator has access to the computer room via a magnetic card and a digital code that is different for each card. The systems analyst and the supervisor of the computer operators do not have access to the computer room.

The EDP system documentation consists of the following items: program listing, error listing, logs, and record layout. To increase efficiency, batch totals and processing controls are omitted from the system.

Ajax ships its products directly from two warehouses which forward shipping notices to general accounting. There, the billing clerk enters the price of the item and accounts for the numerical sequence of the shipping notices. The billing clerk also prepares daily adding machine tapes of the units shipped and the sales amounts. Shipping notices and adding machine tapes are forwarded to the computer department for processing. The computer output consists of:

- A three-copy invoice that is forwarded to the billing clerk, and
- A daily sales register showing the aggregate totals of units shipped and sales amounts that the computer operator compares to the adding machine tapes.

The billing clerk mails two copies of each invoice to the customer and retains the third copy in an open invoice file that serves as a detail accounts receivable record.

Required:

Describe one specific recommendation for correcting each weakness in internal accounting controls in the new EDP system and for correcting each weakness or inefficiency in the procedures for processing and controlling shipping notices and customer invoices.

N85

Number 5 (Estimated time — 15 to 25 minutes)

In 1984 XY Company purchased over \$10 million of office equipment under its "special" ordering system, with individual orders ranging from \$5,000 to \$30,000. "Special" orders entail low volume items which have been included in an authorized user's budget. Department heads include in their annual budget requests the types of equipment and their estimated cost. The budget, which limits the types and dollar amounts of office equipment a department head can requisition, is approved at the beginning of the year by the board of directors. Department heads prepare a purchase requisition form for equipment and forward the requisition

to the purchasing department. XY's "special" ordering system functions as follows:

Purchasing: Upon receiving a purchase requisition, one of five buyers verifies that the person requesting the equipment is a department head. The buyer then selects the appropriate vendor by searching the various vendor catalogs on file. The buyer then phones the vendor, requesting a price quotation, and gives the vendor a verbal order. A prenumbered purchase order is then processed with the original sent to the vendor, a copy to the department head, a copy to receiving, a copy to accounts payable, and a copy filed in the open requisition file. When the buyer is orally informed by the receiving department that the item has been received, the buyer transfers the purchase order from the unfilled file to the filled file. Once a month the buyer reviews the unfilled file to follow up and expedite open orders.

Receiving: The receiving department receives a copy of the purchase order. When equipment is received the receiving clerk stamps the purchase order with the date received, and, if applicable, in red pen prints any differences between quantity on the purchase order and quantity received. The receiving clerk forwards the stamped purchase order and equipment to the requisitioning department head and orally notifies the purchasing department.

Accounts payable: Upon receipt of a purchase order, the accounts payable clerk files the purchase order in the open purchase order file. When a vendor invoice is received, the invoice is matched with the applicable purchase order, and a payable is set up by debiting the equipment account of the department requesting the items. Unpaid invoices are filed by due date and, at due date, a check is prepared. The invoice and purchase order are filed by purchase order number in a paid invoice file, and then the check is forwarded to the treasurer for signature.

Treasurer: Checks received daily from the accounts payable department are sorted into two groups: those over \$10,000 and those \$10,000 and less. Checks for \$10,000 and less are machine-signed. The cashier maintains the key and signature plate to the check-signing machine, and maintains a record of usage of the check-signing machine. All checks over \$10,000 are signed by the treasurer or the controller.

Required:

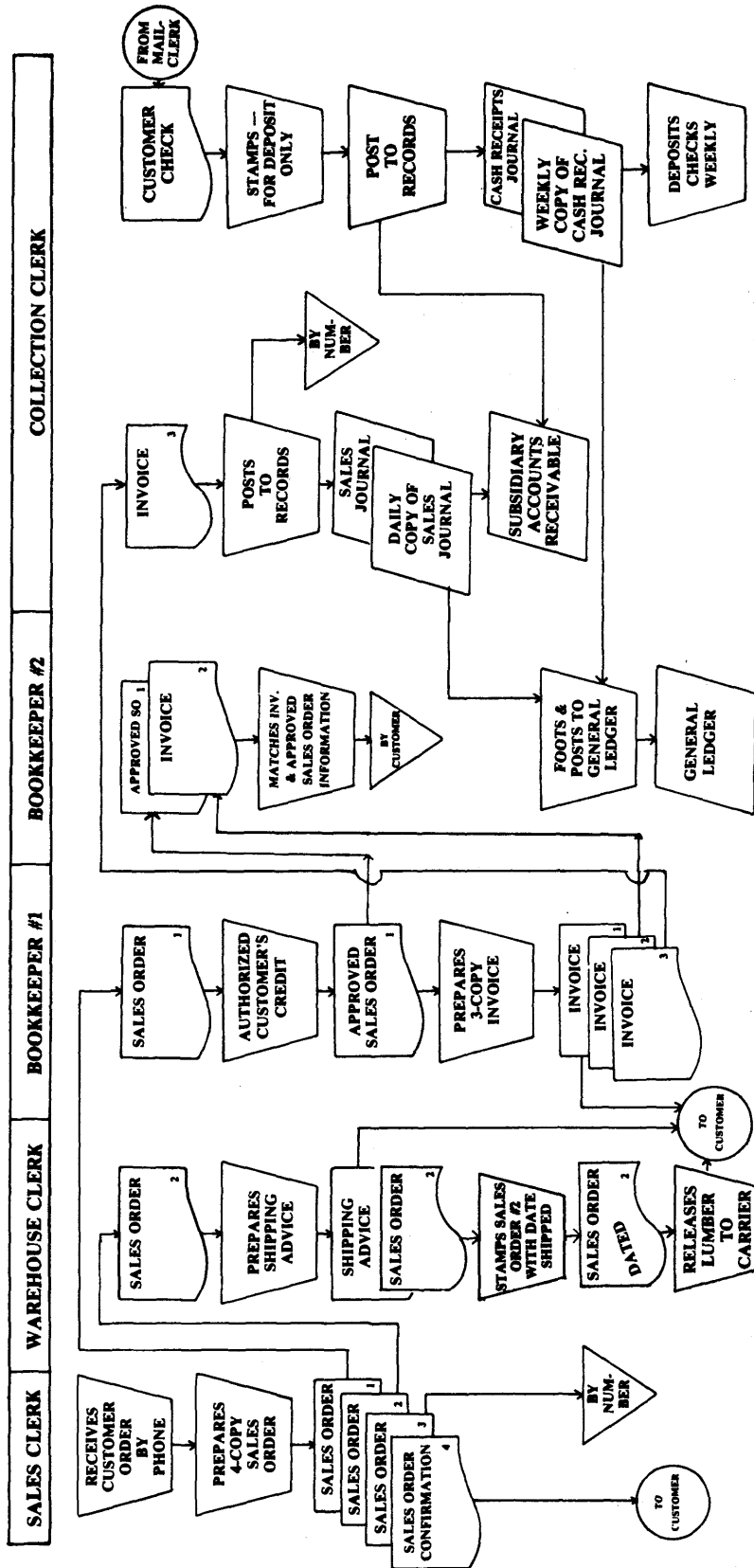
Describe the internal accounting control weaknesses relating to purchases and payments of "special" orders of XY Company for each of the following functions:

- a. Purchasing,
- b. Receiving,
- c. Accounts payable, and
- d. Treasurer.

Selected Questions

M85 Number 3 (Estimated time — — 15 to 25 minutes)

The following flowchart depicts the activities relating to the shipping, billing, and collecting processes used by Smallco Lumber, Inc.



Required:

Identify weaknesses in the system of internal accounting control relating to the activities of a.) warehouse clerk, b.) bookkeeper #1, c.) bookkeeper #2, and d.) collection clerk.

Auditing

C. Cycles

Use the following format:

M89

Number 3 (Estimated time — — 15 to 25 minutes)

Question

Yes

No

Taylor, CPA, has been engaged to audit the financial statements of Johnsons Coat Outlet, Inc., a medium-sized mail-order retail store that sells a wide variety of coats to the public.

Required:

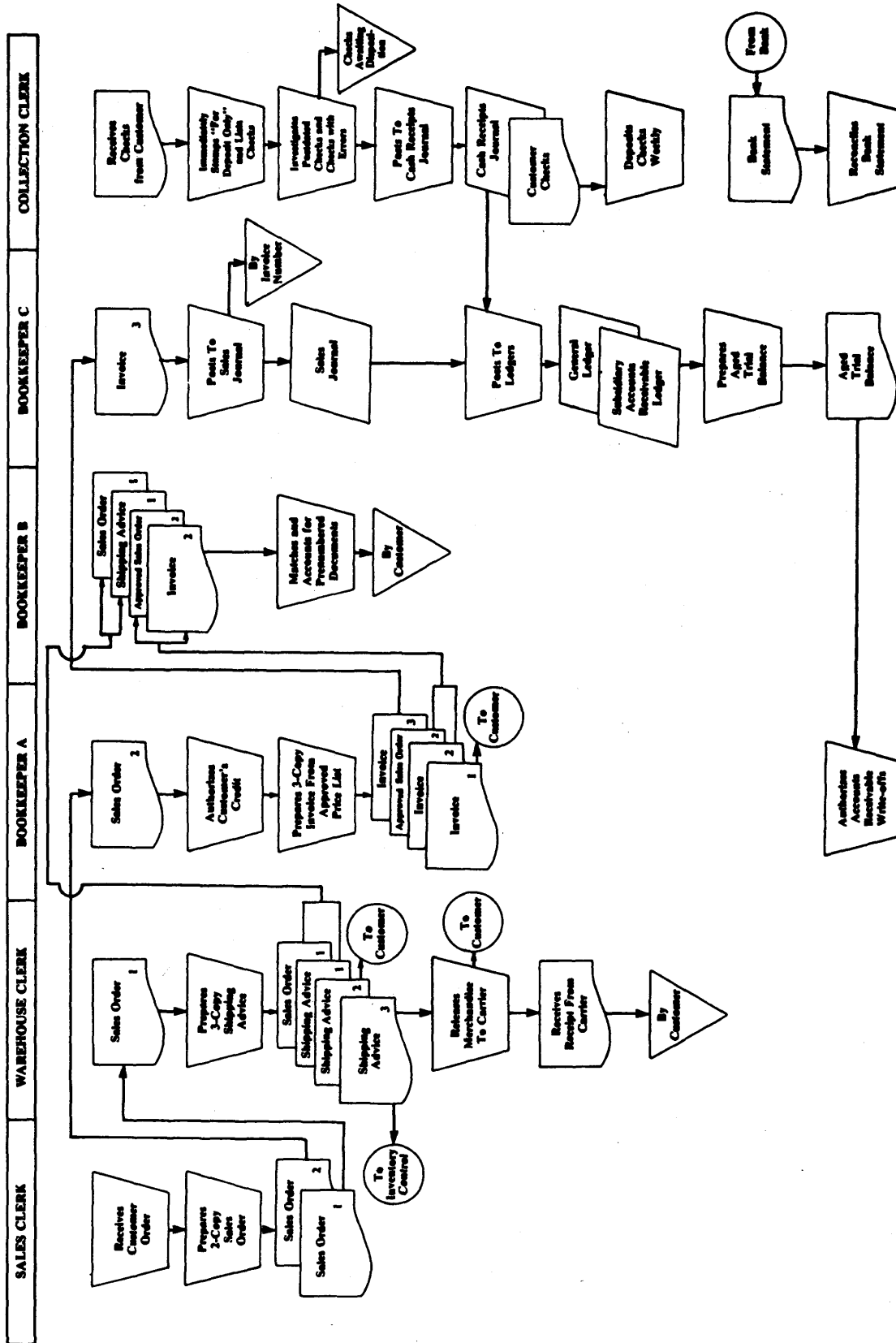
Prepare the "Shipments" segment of Taylor's internal control questionnaire. Each question should elicit either a yes or no response.

Do not prepare questions relating to the cash receipts, sales returns and allowances, billing, inventory control, or other segments.

Selected Questions

M88 Number 4 (Estimated time — 15 to 25 minutes)

The following flowchart depicts the activities relating to the sales, shipping, billing, and collecting processes used by Newton Hardware, Inc.



Required:
 Identify the weaknesses in the system of internal accounting control relating to the activities of a) the warehouse clerk, b) bookkeeper A, and c) the collection clerk.
 Do not identify weaknesses relating to the sales clerk or bookkeepers B and C. Do not discuss recommendations concerning the correction of these weaknesses.

N87

Number 2 (Estimated time — 15 to 25 minutes)

Green, CPA, has been engaged to audit the financial statements of Star Manufacturing, Inc. Star is a medium-sized entity that produces a wide variety of household goods. All acquisitions of materials are processed through the purchasing, receiving, accounts payable, and treasury functions.

Required:

Prepare the "Purchases" segment of the internal accounting control questionnaire to be used in the evaluation of Star's internal accounting control system. Each question should elicit either a yes or no response.

Do **not** prepare the receiving, accounts payable, or treasury segments of the internal accounting control questionnaire.

Do **not** discuss the internal accounting controls over purchases.

M86

Number 4 (Estimated time — 15 to 25 minutes)

Harris, CPA, has been engaged to audit the financial statements of the Spartan Drug Store, Inc. Spartan is a medium sized retail outlet that sells a wide variety of consumer goods. All sales are for cash or check. Cashiers utilize cash registers to process these transactions. There are no receipts by mail and there are no credit card or charge sales.

Required:

Construct the "Processing Cash Collections" segment of the internal accounting control questionnaire on "Cash Receipts" to be used in the evaluation of the system of internal accounting control for the Spartan Drug Store, Inc. Each question should elicit either a yes or no response. Do **not** discuss the internal accounting controls over cash sales.

D. Other Considerations

N88

Number 3 (Estimated time — 15 to 25 minutes)

Sampling for attributes is often used to allow an auditor to reach a conclusion concerning a rate of occurrence in a population. A common use in auditing is

to test the rate of deviation from a prescribed internal accounting control procedure to determine whether planned reliance on that control is appropriate.

Required:

a. When an auditor samples for attributes, identify the factors that should influence the auditor's judgment concerning the determination of

1. Acceptable level of risk of overreliance,
2. Tolerable deviation rate, and
3. Expected population deviation rate.

b. State the effect on sample size of an increase in each of the following factors, assuming all other factors are held constant:

1. Acceptable level of risk of overreliance,
2. Tolerable deviation rate, and
3. Expected population deviation rate.

c. Evaluate the sample results of a test for attributes if authorizations are found to be missing on 7 check requests out of a sample of 100 tested. The population consists of 2500 check requests, the tolerable deviation rate is 8%, and the acceptable level of risk of overreliance is low.

d. How may the use of statistical sampling assist the auditor in evaluating the sample results described in c, above?

M87

Number 4 (Estimated time — 15 to 25 minutes)

Martin, CPA, has been engaged to express an opinion on Beta Manufacturing Company's system of internal accounting control in effect as of June 1, 1987.

Required:

a. Compare Martin's examination of the system of internal accounting control for the purpose of expressing an opinion on it with the study and evaluation of internal accounting control made as part of an examination of the financial statements in accordance with generally accepted auditing standards. The comparison should be made as to the 1) scope, 2) purpose, and 3) timing of the engagements, and 4) users of the reports.

b. Identify the major contents of Martin's report expressing an opinion on Beta's system of internal accounting control. Do **not** draft the report.

Selected Questions

III. Evidence and Procedures

A. Audit Evidence

N88

Number 5 (Estimated time — — 15 to 25 minutes)

The purpose of all auditing procedures is to gather sufficient competent evidence for an auditor to form an opinion regarding the financial statements taken as a whole.

Required:

a. In addition to the example below, identify and describe five means or techniques of gathering audit evidence used to evaluate a client's inventory balance.

<i>Technique</i>	<i>Description</i>
Observation	An auditor watches the performance of some function, such as a client's annual inventory count.

b. Identify the five general assertions regarding a client's inventory balance and describe one **different** substantive auditing procedure for each assertion. Use the format illustrated below.

<i>Assertion</i>	<i>Substantive Auditing Procedure</i>

N86

Number 2 (Estimated time — — 15 to 25 minutes)

Audit risk and materiality should be considered when planning and performing an examination of financial statements in accordance with generally accepted auditing standards. Audit risk and materiality should also be considered together in determining the nature, timing, and extent of auditing procedures and in evaluating the results of those procedures.

Required:

- a.
 1. Define audit risk.
 2. Describe its components of inherent risk, control risk, and detection risk.
 3. Explain how these components are inter-related.
- b.
 1. Define materiality.
 2. Discuss the factors affecting its determination.
 3. Describe the relationship between materiality for planning purposes and materiality for evaluation purposes.

N85

Number 4 (Estimated time — — 15 to 25 minutes)

The CPA firm of Wright & Co. is in the process of examining William Corporation's 1984 financial statements. The following open matters must be resolved before the audit can be completed:

(1) No audit work has been performed on nonresponses to customer accounts receivable confirmation requests. Both positive and negative confirmations were used. A second request was sent to debtors who did not respond to the initial positive request.

(2) The client representation letter has not been completed and signed by William's management. Wright has started to outline the content of the representation letter and believes the following matters should be included in the letter: Management should acknowledge whether or not

- All material transactions have been properly reflected in the financial statements.

- It is aware of irregularities that could have a material effect on the financial statements or that involve management or employees.

- Events have occurred subsequent to the balance sheet date that would require adjustment to, or disclosure in, the financial statement.

- There are any communications from regulatory agencies concerning noncompliance with, or deficiencies in, financial reporting practices.

- The company has complied with all aspects of contractual agreements that would have a material effect on the financial statements in the event of non-compliance.

- There are any plans or intentions that may materially affect the carrying value or classification of assets or liabilities.

- There are any losses from sales commitments.

- There are any losses from purchase commitments for inventory quantities in excess of requirements or at prices in excess of market.

- There are any agreements to repurchase assets previously sold.

- There are any violations or possible violations of laws or regulations whose effects should be considered for disclosure in the financial statements or as a basis for recording a loss contingency.

- There are any capital stock repurchase options or agreements or capital stock reserved for options, warrants, conversions, or other requirements.

Required:

a. What alternative audit procedures should Wright consider performing on the nonresponses to customer accounts receivable confirmation requests?

b. Identify the other matters that Wright would expect to be included in William's management representation letter.

Auditing

M85

Number 4 (Estimated time — — 15 to 25 minutes)

Smith is the partner in charge of the audit of Blue Distributing Corporation, a wholesaler that owns one warehouse containing 80% of its inventory. Smith is reviewing the working papers that were prepared to support the firm's opinion on Blue's financial statements and Smith wants to be certain essential audit records are well-documented.

Required:

a. What evidence should Smith find in the working papers to support the fact that the audit was adequately planned and the assistants were properly supervised?

b. What substantive tests should Smith expect to find in the working papers to document management's assertion about completeness as it relates to the inventory quantities at the end of the year?

B. Specific Audit Objectives and Procedures

M89

Number 4 (Estimated time — — 15 to 25 minutes)

Edwards, CPA, is engaged to audit the financial statements of Matthews Wholesaling for the year ended December 31, 1988. Edwards obtained and documented an understanding of the internal control structure relating to the accounts receivable and assessed control risk relating to accounts receivable at the maximum level. Edwards requested and obtained from Matthews an aged accounts receivable schedule listing the total amount owed by each customer as of December 31, 1988, and sent positive confirmation requests to a sample of the customers.

Required:

What additional substantive audit procedures should Edwards consider applying in auditing the accounts receivable?

M88

Number 3 (Estimated time — — 15 to 25 minutes)

Young, CPA, is considering the procedures to be applied concerning a client's loss contingencies relating to litigation, claims, and assessments.

Required:

What substantive audit procedures should Young apply when testing for loss contingencies relating to litigation, claims, and assessments?

N87

Number 3 (Estimated time — — 15 to 25 minutes)

MLG Company's auditor received directly from the banks, confirmations and cut-off statements with related checks and deposit tickets for MLG's three general-purpose bank accounts. The auditor determined that internal accounting control over cash was satisfactory and will be relied upon. The proper cut-off of external cash receipts and disbursements was established. No bank accounts were opened or closed during the year.

Required:

Prepare the audit program of substantive procedures to verify MLG's bank balances. Ignore any other cash accounts.

M86

Number 2 (Estimated time — — 15 to 25 minutes)

Jones, CPA, the continuing auditor of Sussex, Inc., is beginning the audit of the common stock and treasury stock accounts. Jones has decided to design substantive tests without reliance on internal accounting control.

Sussex has no par, no stated value common stock and acts as its own registrar and transfer agent. During the past year Sussex both issued and reacquired shares of its own common stock, some of which the company still owned at year-end. Additional common stock transactions occurred among the shareholders during the year.

Common stock transactions can be traced to individual shareholders' accounts in a subsidiary ledger and to a stock certificate book. The company has not paid any cash or stock dividends. There are no other classes of stock, stock rights, warrants, or option plans.

Required:

What substantive audit procedures should Jones apply in examining the common stock and treasury stock accounts?

N85

Number 2 (Estimated time — — 15 to 25 minutes)

The CPA firm of May & Marty has audited the consolidated financial statements of BGI Corporation. May & Marty performed the examination of the parent company and all subsidiaries except for BGI-Western Corporation, which was audited by the CPA firm of Dey & Dee. BGI-Western constituted approximately 10% of the consolidated assets and 6% of the consolidated revenue.

Selected Questions

Dey & Dee issued an unqualified opinion on the financial statements of BGI-Western. May & Marty will be issuing an unqualified opinion on the consolidated financial statements of BGI.

Required:

a. What procedures should May & Marty consider performing with respect to Dey & Dee's examination of BGI-Western's financial statements that will be appropriate whether or not reference is to be made to the other auditors?

b. Describe the various circumstances under which May & Marty could take responsibility for the work of Dey & Dee and make no reference to Dey & Dee's examination of BGI-Western in May & Marty's auditor's report on the consolidated financial statements of BGI.

C. Other Specific Audit Topics

N88

Number 2 (Estimated time — 15 to 25 minutes)

Temple, CPA, is auditing the financial statements of Ford Lumber Yards, Inc., a privately-held corporation with 300 employees and five stockholders, three of whom are active in management. Ford has been in business for many years, but has never had its financial statements audited. Temple suspects that the substance of some of Ford's business transactions differ from their form because of the pervasiveness of related party relationships and transactions in the local building supplies industry.

Required:

Describe the audit procedures Temple should apply to identify related party relationships and transactions.

N87

Number 4 (Estimated time — 15 to 25 minutes)

Microcomputer software has been developed to improve the efficiency and effectiveness of the audit. Electronic spreadsheets and other software packages are available to aid in the performance of audit procedures otherwise performed manually.

Required:

Describe the potential benefits to an auditor of using microcomputer software in an audit as compared to performing an audit without the use of a computer.

M87

Number 3 (Estimated time — 15 to 25 minutes)

Edwards has decided to use Probability Proportional to Size (PPS) sampling, sometimes called dollar-unit sampling, in the audit of a client's accounts receivable balance. Few, if any, errors of account balance overstatement are expected.

Edwards plans to use the following PPS sampling table:

TABLE
Reliability Factors for Errors of Overstatement

Number of Over- statement Errors	Risk of Incorrect Acceptance				
	1%	5%	10%	15%	20%
0	4.61	3.00	2.31	1.90	1.61
1	6.64	4.75	3.89	3.38	3.00
2	8.41	6.30	5.33	4.72	4.28
3	10.05	7.76	6.69	6.02	5.52
4	11.61	9.16	8.00	7.27	6.73

Required:

a. Identify the advantages of using PPS sampling over classical variables sampling.

Note: Requirements b and c are **not** related.

b. Calculate the sampling interval and the sample size Edwards should use given the following information:

Tolerable error.....	\$15,000
Risk of incorrect acceptance	5%
Number of errors allowed.....	0
Recorded amount of accounts receivable	\$300,000

Note: Requirements b and c are **not** related.

c. Calculate the total projected error if the following three errors were discovered in a PPS sample:

	Recorded Amount	Audit Amount	Sampling Interval
1st error	\$ 400	\$ 320	\$1,000
2nd error	500	0	1,000
3rd error	3,000	2,500	1,000

M86

Number 5 (Estimated time — 15 to 25 minutes)

Smith, CPA, has decided to rely on an audit client's internal accounting controls affecting receivables. Smith plans to use sampling to obtain substantive evidence concerning the reasonableness of the client's accounts receivable balances. Smith has identified the first few steps in an outline of the sampling plan as follows:

1. Determine the audit objectives of the test.
2. Define the population.
3. Define the sampling unit.
4. Consider the completeness of the population.
5. Identify individually significant items.

Required:

Identify the remaining steps which Smith should include in the outline of the sampling plan. Illustrations and examples need **not** be provided.

Auditing

M85

Number 5 (Estimated time — — 15 to 25 minutes)

One of the generally accepted auditing standards states that sufficient competent evidential matter is to be obtained through inspection, observation, inquiries, and confirmation to afford a reasonable basis for an opinion regarding the financial statements under examination. Some degree of uncertainty is implicit in the concept of "a reasonable basis for an opinion," because the concept of sampling is well established in auditing practice.

Required:

- a. Explain the auditor's justification for accepting the uncertainties that are inherent in the sampling process.
- b. Discuss the uncertainties which collectively embody the concept of ultimate audit risk.
- c. Discuss the nature of the sampling risk and nonsampling risk. Include the effect of sampling risk on substantive tests of details and on compliance tests of internal accounting control.

IV. Reporting

In April 1988, the Auditing Standards Board issued *Statement on Auditing Standards No. 58, "Reports on Audited Financial Statements,"* superseding SAS No. 2, *"Reports on Audited Financial Statements"* (1974). Accordingly, all previous examination items covered by SAS No. 2 have been deleted.

A. Reporting Standards and Types of Reports

M89

Number 2 (Estimated time — — 15 to 25 minutes)

The auditors' report below was drafted by a staff accountant of Turner & Turner, CPAs, at the completion of the audit of the financial statements of Lyon Computers, Inc., for the year ended March 31, 1989. It was submitted to the engagement partner who reviewed matters thoroughly and properly concluded that Lyon's disclosures concerning its ability to continue as a going concern for a reasonable period of time were adequate. Early application of Statement on Auditing Standards No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, was chosen by Turner & Turner.

To the Board of Directors of Lyon Computers, Inc.:

We have audited the accompanying balance sheet of Lyon Computers, Inc. as of March 31, 1989, and the other related financial statements for the year then ended. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with standards that require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are in conformity with generally accepted accounting principles. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management.

The accompanying financial statements have been prepared assuming that the Company will continue as a going concern. As discussed in Note X to the financial

statements, the Company has suffered recurring losses from operations and has a net capital deficiency that raise substantial doubt about its ability to continue as a going concern. We believe that management's plans in regards to these matters, which are also described in Note X, will permit the Company to continue as a going concern beyond a reasonable period of time. The financial statements do not include any adjustments that might result from the outcome of this uncertainty.

In our opinion, subject to the effects on the financial statements of such adjustments, if any, as might have been required had the outcome of the uncertainty referred to in the preceding paragraph been known, the financial statements referred to above present fairly, in all material respects, the financial position of Lyon Computers, Inc., and the results of its operations and its cash flows in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Turner & Turner, CPAs
April 28, 1989

Required:

Identify the deficiencies contained in the auditor's report as drafted by the staff accountant. Group the deficiencies by paragraph. Do **not** redraft the report.

N88

Number 4 (Estimated time — — 15 to 25 minutes)

The following report on the basic financial statements was drafted by a staff assistant at the completion of the review engagement of GLM Company, a continuing client, for the year ended September 30, 1988. The 1987 basic financial statements for the year ended September 30, 1987, which were also reviewed, con-

Selected Questions

tained a departure from generally accepted accounting principles that was properly referred to in the 1987 review report dated October 26, 1987. The 1987 financial statements have been restated.

To the Board of Directors of GLM Company:

We have reviewed the accompanying balance sheets of GLM Company as of September 30, 1988 and 1987, and the related statements of income and retained earnings for the years then ended, in accordance with generally accepted auditing standards. Our review included such tests of the accounting records as we considered necessary in the circumstances.

A review consists principally of inquiries of company personnel. It is substantially less in scope than an audit, but more in scope than a compilation. Accordingly, we express only limited assurance on the accompanying financial statements.

Based on our reviews, with the exception of the matter described in the following paragraph, we are not aware of any material modifications that should be made to the accompanying financial statements in order for them to be in conformity with generally accepted accounting principles applied on a consistent basis.

In its 1987 financial statements the company stated its land at appraised values. However, as disclosed in note X, the company has restated its 1987 financial statements to reflect land at cost.

November 2, 1988

Required:

Identify the deficiencies in the draft of the proposed report on the comparative financial statements. Group the deficiencies by paragraph. Do **not** redraft the report.

M88

Number 2 (Estimated time — — 15 to 25 minutes)

An accountant is sometimes called on by clients to report on or assemble prospective financial statements for use by third parties.

Required:

- b. Describe the contents of the accountant's standard report on a compilation of a financial projection.

M87

Number 2 (Estimated time — — 15 to 25 minutes)

The following report was drafted by a staff assistant at the completion of the calendar year 1986 review engagement of RLG Company, a continuing client. The 1985 financial statements were compiled. On March 6, 1987, the date of the completion of the review, the report was submitted to the partner with client responsibility. The financial statements for 1985 and 1986 are presented in comparative form.

To the Board of Directors of RLG Company

We have reviewed the accompanying financial statements of RLG Company for the year ended December 31, 1986, in accordance with standards established by Statements on Standards for Auditing and Review Services.

A review consists principally of analytical procedures applied to financial data. It is substantially more in scope than a compilation, but less in scope than an examination in accordance with generally accepted auditing standards, the objective of which is the expression of an opinion regarding the financial statements taken as a whole.

Based on our compilation and review, we are not aware of any material modifications that should be made to the 1985 and 1986 financial statements in order for them to be consistent with the prior year's financial statements.

The accompanying 1985 financial statements of RLG Company were compiled by us and, accordingly, we do not express an opinion on them.

March 6, 1987

Required:

Identify the deficiencies in the draft of the proposed report. Group the deficiencies by paragraph. Do **not** redraft the report.

B. Other Reporting Considerations

N85

Number 2 (Estimated time — — 15 to 25 minutes)

The CPA firm of May & Marty has audited the consolidated financial statements of BGI Corporation. May & Marty performed the examination of the parent company and all subsidiaries except for BGI-Western Corporation, which was audited by the CPA firm of Dey & Dee. BGI-Western constituted approximately 10% of the consolidated assets and 6% of the consolidated revenue.

Dey & Dee issued an unqualified opinion on the financial statements of BGI-Western. May & Marty will be issuing an unqualified opinion on the consolidated financial statements of BGI.

Required:

- a. What procedures should May & Marty consider performing with respect to Dey & Dee's examination of BGI-Western's financial statements that will be appropriate whether or not reference is to be made to the other auditors?

- b. Describe the various circumstances under which May & Marty could take responsibility for the work of Dey & Dee and make no reference to Dey & Dee's examination of BGI-Western in May & Marty's auditor's report on the consolidated financial statements of BGI.

SELECTED ESSAYS — UNOFFICIAL ANSWERS

I. Professional Responsibilities

M89

Answer 5 (10 points)

a. To satisfy an auditor's responsibilities to detect Smith's errors and irregularities, Reed should

- Assess the risk that Smith's errors and irregularities may cause its financial statements to contain a material misstatement.
- Design the audit to provide reasonable assurance of detecting errors and irregularities that are material to the financial statements.
- Exercise due care in planning, performing, and evaluating the results of audit procedures, and the proper degree of professional skepticism to achieve reasonable assurance that material errors or irregularities will be detected.

b. To satisfy an auditor's responsibilities to report Smith's errors and irregularities, Reed should

- Inform Smith's audit committee, or others having equivalent authority and responsibility, about material irregularities of which Reed becomes aware.
- Express a qualified or an adverse opinion on the financial statements if they are materially affected by an error or irregularity and are not revised.
- Disclaim or qualify an opinion on the financial statements and communicate the findings to the audit committee or the board of directors if the scope of the audit has been restricted concerning a possible irregularity.
- Consider notification of outside parties concerning irregularities in certain circumstances.

c. Reed's responsibilities to detect Smith's illegal acts that have a material and direct effect on Smith's financial statements are the same as that for errors and irregularities.

Reed's responsibilities to detect Smith's illegal acts that have a material and indirect effect on the financial statements are to be aware of the possibility that such illegal acts may have occurred. If specific information comes to Reed's attention that provides evidence concerning the existence of such possible illegal acts, Reed should apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.

d. In an audit to which GAO standards apply, Reed should additionally

- Determine that instances or apparent indications of illegal acts are reported to the funding agency or other specified agency.
- Express positive assurance on whether the items tested were in compliance with applicable laws and regulations.
- Express negative assurance that, except as otherwise noted, nothing came to Reed's attention that caused Reed to believe that the untested items were not in compliance with applicable laws and regulations.

M88

Answer 2

a. 1. An accountant who reports on or assembles prospective financial statements for use by third parties should perform any one of three engagements. The accountant may compile, examine, or apply agreed-upon procedures to the prospective financial statements.

2. "General use" of prospective financial statements refers to use of the statements by persons (creditors, stockholders, etc.) with whom the responsible party (management) is not negotiating directly. "Limited use" of prospective financial statements refers to the use of prospective financial statements by the responsible party alone or by the responsible party and third parties with whom the responsible party is negotiating directly.

3. Only a financial forecast is appropriate for general use, but any type of prospective financial statements (either a financial forecast or a financial projection) would normally be appropriate for limited use.

M87

Answer 5 (10 points)

Additional procedures to be performed prior to the beginning of field work are:

5. Read the current year's interim financial statements.
6. Discuss the scope of the examination with management of the client.

Auditing

7. Establish the timing of the audit work.
8. Arrange with the client for adequate working space.
9. Coordinate the assistance of client personnel in data preparation.
10. Establish and coordinate staffing requirements including time budget.
11. Hold a planning conference with assistants assigned to the engagement.
12. Determine the extent of involvement, if any, of consultants, specialists, and internal auditors.
13. Consider the effects of applicable accounting and auditing pronouncements, particularly recent ones.
14. Consider the need for an appropriate engagement letter.
15. Prepare documentation setting forth the preliminary audit plan.
16. Make preliminary judgment about materiality levels.
17. Make preliminary judgment about reliance to be placed on internal accounting controls.
18. Update the prior year's written audit program.

II. Internal Control

B. Consideration of the Internal Control Structure

N86

Answer 4 (10 points)

Recommendations for correcting weaknesses in the internal accounting controls in the new EDP system and weaknesses and inefficiencies in the procedures for processing and controlling shipping notices and customer invoices:

- The functions of programming, machine operations, and control should be assigned to different employees.
- Computer log should be reconciled by the computer operations supervisor or other independent employee.
- Access to tapes and documentation should be controlled by an independent employee or through the use of restricted authorization code.
- Programmers' access to computers should be limited to testing and debugging.
- The supervisor of the computer operators should have access to the computer room.
- The EDP system's documentation should also include flowcharts, computer programs, and operator instructions.
- Batch totals (control totals, hash totals, record counts) should be utilized to assure that data have been properly authorized and not lost or otherwise improperly changed.
- Processing controls should be put in place to assure that errors in the input records will be detected when processing occurs. Among the possible processing controls are completeness tests, validation tests, sequence tests, and limit or reasonableness tests.

• The price list should be placed on a master file in the computer and matched with product numbers on the shipping notices to obtain appropriate prices.

• The computer should be programmed to review the numerical sequence of shipping notices and list missing numbers.

• The billing clerk or other designated control clerk should retain the adding machine tapes or a copy of them to compare the total with the daily sales register.

• Copies of invoices should be forwarded by the computer department to the mailroom clerk for mailing to the customers.

• An individual who is independent of billing and cash collections should maintain the accounts receivable records; or if the records are updated by the computer department, there should be an independent review by general accounting.

• The accounts receivable records maintained manually in an open file should be more efficiently maintained on magnetic tape.

N85

Answer 5 (10 points)

XY Company's major internal accounting control weaknesses are:

Purchasing:

- The buyer does not verify that the department head's request is within budget limitations.
- No procedures have been established to assure that the best price is obtained. Large dollar requisitions should be ordered after receiving quotes and/or sealed bids.
- Prior to placing an order, the buyer does not determine the adequacy of the vendor's past record as a supplier to XY.

Unofficial Answers

Receiving:

- Receiving clerk does not make blind counts for all special equipment or at least for large dollar items.
- Written notice of equipment received is not sent to purchasing.
- Written notice of equipment received is not sent to accounts payable.

Accounts Payable:

- The mathematical accuracy of the invoice is not re-computed.
- Invoice quantity is not compared with a report of quantity received.
- Notification of the acceptability of the equipment from the requisitioning department is not obtained before the payable is recorded.
- No alphabetic file of vendors from whom purchases are made is maintained.

Treasurer:

- Documentation supporting the checks is not sent by the accounts payable department to the cashier in order for the cashier or treasurer to be assured that the check is for properly authorized and received equipment.
- Checks for large dollar purchases are not signed by two officers of XY Company to assure that material expenditures are proper.
- All documentation to support a check is not canceled by the check-signer and returned to the accounts payable department.
- The cashier alone has custody of the key, the signature plate, and record of usage.
- The controller is authorized to sign checks.

M85

Answer 3 (10 points)

The weaknesses in Smallco Lumber's internal accounting controls are these:

Warehouse Clerk

- Releases lumber prior to authorization, for example, approval of customer's credit.
- Copies of shipping advice should be prepared and forwarded to Bookkeeper #1.
- Lacks documentation that lumber was given to the carrier.

Bookkeeper #1

- Credit authorized by bookkeeper and not a responsible officer.
- Prepares and mails invoice without knowledge of what was shipped.

Bookkeeper #2

- Bookkeeper who maintains general ledger should not be responsible for footing and crossfooting of journals, that is, sales and cash receipts journals.
- Subsidiary accounts receivable ledger should be reconciled to general ledger.

Collection Clerk

- Collection clerk should not maintain sales journal.
- Collection clerk should not maintain accounts receivable subsidiary ledger.
- Remittance advice not used as the basis for posting collections.
- Checks are not promptly endorsed by the mail clerk.
- Cash receipts are not promptly deposited.
- Deposit slips are not reconciled to cash receipts journal or debits to general ledger.

C. Cycles

M89

Answer 3 (10 points)

JOHNSONS COAT OUTLET, INC. Shipments Internal Control Questionnaire

<u>Question</u>	<u>Yes</u>	<u>No</u>
1. Are shipping documents prepared from sales orders approved in accordance with management's authorization?		
2. Are shipping documents pre-numbered?		
3. Are shipping documents periodically accounted for?		
4. Are shipping documents recorded in a register, log, or file?		
5. Are copies of shipping documents forwarded to the Billing department? Inventory control department?		
6. Do shipping documents include cross reference to sales orders; customer identity and address; description and quantities of goods shipped; date; and other details?		
7. Is the shipping function independent of Sales orders? Credit approval? Billing and accounts receivable? Cash receipts? Warehouse? Receiving? Inventory Control?		

Auditing

<u>Question</u>	<u>Yes</u>	<u>No</u>
8. Is access to merchandise restricted and controlled within the shipping department?		
9. Are type and quantities of goods withdrawn and packed for shipping verified by independent counts?		
10. Are receipts from carriers obtained and filed?		

M88

Answer 4 (10 points)

The weaknesses in Newton Hardware's internal accounting controls include these:

Warehouse Clerk

- Initiates posting to inventory records by preparation of shipping advice.
- Releases merchandise to customers before proper approvals of customers' credit.
- Does not retain a copy of the shipping advice for comparison with receipt from carrier.

Bookkeeper A

- Authorizes customers' credit and prepares source documents for posting to customers' accounts.
- Prepares invoices without notice that the merchandise was actually shipped and the date it was shipped.
- Authorizes write-offs of customer accounts receivable and authorizes customers' credit.

Collection Clerk

- Receives directly and records customers' checks.
- Does not deliver checks excluded from the deposit to an employee independent of the bank deposit for review and disposition.
- Initiates posting of receipts to subsidiary accounts receivable ledger and has initial access to cash receipts.
- Does not deposit cash receipts promptly.
- Reconciles bank statement and has initial access to cash receipts.

N87

Answer 2 (10 points)

STAR MANUFACTURING, INC.

Purchases

Internal Accounting Control Questionnaire

<u>Question</u>	<u>Yes</u>	<u>No</u>
1. Are there written purchasing policies and procedures?		
2. Are purchase requisitions approved in accordance with management's authorization?		

<u>Question</u>	<u>Yes</u>	<u>No</u>
3. Are purchases made from approved vendors?		
4. Are price quotations requested for purchases over an established amount?		
5. Are purchase commitments documented on written purchase order forms?		
6. Do purchase orders include adequate descriptions, terms, and instructions?		
7. Are purchase orders approved by authorized personnel before issuance?		
8. Are prenumbered purchase order forms periodically accounted for?		
9. Is a detailed listing of purchase orders maintained?		
10. Is the purchasing function independent of receiving, shipping, invoice processing, and treasury functions?		
11. Are there adequate safeguards over unissued purchase order forms?		
12. Are old items in the open purchase order file periodically investigated?		
13. Are vendors notified of conflict of interest policies?		

M86

Answer 4 (10 points)

SPARTAN DRUG STORE, INC.

Processing Cash Collections

Internal Accounting Control Questionnaire

<u>Question</u>	<u>Yes</u>	<u>No</u>
Are customers who pay by check identified via store I.D. card or other means?		
Does company policy prohibit accepting checks for anything except merchandise sales plus a nominal cash amount?		
Is a receipt produced by the cash register given to each customer?		
Is the reading of each cash register taken periodically by an employee who is independent of the handling of cash receipts?		
Are cash counts made on a surprise basis by an individual who is independent of the handling of cash receipts?		

Unofficial Answers

Question

Is the reading of each cash register compared regularly to the cash received?

Is a summary listing of cash register readings prepared by an employee who is independent of physically handling cash receipts?

Are receipts forwarded to an independent employee who makes the bank deposits?

Are each day's receipts deposited intact daily?

Is the summary listing of cash register receipts reconciled to the duplicate deposit slips authenticated by the bank?

Are entries to the cash receipts journal prepared from duplicate deposit slips or the summary listing of cash register readings?

Are the entries to the cash receipts journal compared to the deposits per bank statement?

Are areas involving the physical handling of cash reasonably safeguarded?

Are employees who handle receipts bonded?

Are charged back items (NSF checks, etc.) directed to an employee who does not physically handle receipts or have access to the books?

D. Other Considerations

N88

Answer 3 (10 points)

a. 1. In determining an acceptable level of risk of overreliance, an auditor should consider the importance of the control to be tested in determining the extent to which substantive tests will be restricted and the planned degree of reliance on that control.

2. In determining the tolerable deviation rate, an auditor should consider the planned degree of reliance on the control to be tested and how materially the financial statements would be affected if the control does not function properly. For example, how likely is the control to prevent or detect material errors.

3. In determining the expected population deviation rate, an auditor should consider the results of prior years' tests, the overall control environment, or utilize a preliminary sample.

Yes No

b. 1. There is a decrease in sample size if the acceptable level of risk of overreliance is increased.

2. There is a decrease in sample size if the tolerable deviation rate is increased.

3. There is an increase in sample size if the population deviation rate is increased.

c. For a low risk of overreliance it is generally appropriate to reconsider the planned reliance as the calculated estimate of the population deviation rate identified in the sample (7%) approaches the tolerable deviation rate (8%). This is because there may be an unacceptably high sampling risk that these sample results could have occurred with an actual population deviation rate higher than the tolerable deviation rate.

d. If statistical sampling is used, an allowance for sampling risk can be calculated. If the calculated estimate of the population deviation rate plus the allowance for sampling risk is greater than the tolerable deviation rate, the sample results should be interpreted as not supporting the planned reliance on the control.

M87

Answer 4 (10 points)

a. 1. An engagement to express an opinion on an entity's system of internal accounting control and a study and evaluation of internal accounting control made as part of an examination of financial statements in accordance with generally accepted auditing standards generally differ in scope. While the engagement to express an opinion on an entity's system can be made in conjunction with the study and evaluation made as part of an examination, the study and evaluation made as part of an examination is more limited in scope.

2. The engagements also differ in purpose. The auditor's study and evaluation of internal accounting control is an intermediate step in forming an opinion on the financial statements. It establishes a basis for reliance on the control system and for determining the nature, extent, and timing of the auditing procedures. The purpose of the accountant's engagement to express an opinion on the system of internal accounting control is to provide assurance about whether the broad objectives of internal accounting control are being achieved.

3. An engagement to express an opinion on an entity's system of internal accounting control can be made as of any date, while the auditor's study and evaluation of internal accounting control is made in the early stages of an audit with review to determine the effectiveness throughout the period.

4. Ordinarily, the users of an opinion on an entity's system of internal accounting control are the client's management or third parties, such as regulatory agencies. The primary user of a study and evaluation of internal accounting control made as part of an audit is the auditor who makes the study and evaluation.

Auditing

- b.** The accountant's report expressing an opinion on an entity's system of internal accounting control should contain
 - a. A description of the scope of the engagement.
 - b. The date to which the opinion relates.
 - c. A statement that the establishment and maintenance of the system is the responsibility of management.
 - d. A brief explanation of the broad objectives and inherent limitations of internal accounting control.
 - e. The accountant's opinion on whether the system meets the broad objectives of internal accounting control insofar as those objectives pertain to the prevention or detection of material errors or irregularities.
 - f. The description of any material weakness.

Unofficial Answers

III. Evidence and Procedures

A. Audit Evidence

N88

Answer 5 (10 points)

a. The means or techniques of gathering audit evidence, in addition to the example, are as follows:

<i>Technique</i>	<i>Description</i>
Inquiry	An auditor questions client personnel about events and conditions, such as obsolete inventory.
Confirmation	An auditor obtains acknowledgments in writing from third parties of transactions or balances, such as inventory in public warehouses or on consignment.
Calculation or Recomputation	An auditor recomputes certain amounts, such as the multiplication of quantity times price to determine inventory amounts.
Analysis	An auditor combines amounts in meaningful ways to allow the application of audit judgment, such as the determination of whether a proper inventory cutoff was performed.
Inspection	An auditor examines documents relating to transactions and balances, such as shipping and receiving records to establish ownership of inventory.
Comparison	An auditor relates two or more amounts, such as inventory cost in perpetual inventory records to costs as shown on vendor invoices as part of the evaluation of whether inventory is priced at the lower of cost or market.

b. Substantive auditing procedures that would satisfy the five general assertions regarding a client's inventory balance include the following:

(one different procedure required for each assertion)

<i>Assertion</i>	<i>Substantive Auditing Procedure</i>
1. Existence or Occurrence	<ul style="list-style-type: none"> ● Observe physical inventory counts. ● Obtain confirmation of inventories at locations outside the entity. ● Test inventory transactions between a preliminary physical inventory date and the balance sheet date. ● Review perpetual inventory records, production records, and purchasing records for indications of current activity. ● Compare inventories with a current sales catalog and subsequent sales and delivery reports. ● Use the work of specialists to corroborate the nature of specialized products.
2. Completeness	<ul style="list-style-type: none"> ● Observe physical inventory counts. ● Analytically review the relationship of inventory balances to recent purchasing, production, and sales activities. ● Test shipping and receiving cutoff procedures. ● Obtain confirmation of inventories at locations outside the entity. ● Trace test counts recorded during the physical inventory observation to the inventory listing. ● Account for all inventory tags and count sheets used in recording the physical inventory counts. ● Test the clerical accuracy of inventory listings. ● Reconcile physical counts to perpetual records and general ledger balances and investigate significant fluctuations.

N88

Answer 5 (continued)

Assertion	Substantive Auditing Procedure
3. Rights and Obligations	<ul style="list-style-type: none"> ● Observe physical inventory counts. ● Obtain confirmation of inventories at locations outside the entity. ● Examine paid vendors' invoices, consignment agreements, and contracts. ● Test shipping and receiving cutoff procedures.
4. Valuation or Allocation	<ul style="list-style-type: none"> ● Examine paid vendors' invoices. ● Review direct labor rates. ● Test the computation of standard overhead rates. ● Examine analyses of purchasing and manufacturing standard cost variances. ● Examine an analysis of inventory turnover. ● Review industry experience and trends. ● Analytically review the relationship of inventory balances to anticipated sales volume. ● Tour the plant. ● Inquire of production and sales personnel concerning possible excess or obsolete inventory items. ● Obtain current market value quotations. ● Review current production costs. ● Examine sales after year-end and open purchase order commitments.
5. Presentation and Disclosure	<ul style="list-style-type: none"> ● Review drafts of the financial statements. ● Compare the disclosures made in the financial statements to the requirements of generally accepted accounting principles. ● Obtain confirmation of inventories pledged under loan agreements.

N86

Answer 2 (10 points)

a. 1. Audit risk is the risk that the auditor may unknowingly fail to appropriately modify the auditor's opinion on financial statements that are materially misstated.

2. Inherent risk is the susceptibility of an account balance or class of transactions to error that could be material, when aggregated with error in other balances or classes, assuming that there were no related internal accounting controls.

Control risk is the risk that error that could occur in an account balance or class of transactions and that could be material, when aggregated with error in other balances or classes, will not be prevented or detected on a timely basis by the system of internal accounting control.

Detection risk is the risk that an auditor's procedures will lead the auditor to conclude that error in an account balance or class of transactions that could be material, when aggregated with error in other balances or classes, does not exist when in fact such error does exist.

3. Inherent risk and control risk differ from detection risk in that they exist independently of the audit of financial statements, whereas detection risk relates to the auditor's procedures and can be changed at the auditor's discretion. Detection risk should bear an inverse relationship to inherent and control risk. The less the inherent and control risk the auditor believes exists, the greater the acceptable detection risk. Conversely, the greater the inherent and control risk the auditor believes exists, the less the acceptable detection risk.

b. 1. Materiality is the magnitude of an omission or misstatement of accounting information that, in the light of surrounding circumstances, makes it probable that the judgment of a reasonable person relying on the information would have been changed or influenced by the omission or misstatement. This concept recognizes that some matters, either individually or in the aggregate, are important for the fair presentation of financial statements in conformity with generally accepted accounting principles, while other matters are not important.

2. Materiality is affected by the nature and amount of an item in relation to the nature and amount of items in the financial statements under examination, and the auditor's judgment as influenced by the auditor's perception of the needs of a reasonable person who will rely on the financial statements.

3. The auditor's judgment about materiality for planning purposes is ordinarily different from materiality for evaluation purposes because the auditor, when planning an audit, cannot anticipate all of the circumstances that may ultimately influence judgment about materiality in evaluating the audit findings at the completion of the audit. If significantly lower materiality levels become appropriate in evaluating the audit findings, the auditor should reevaluate the sufficiency of the audit procedures already performed.

Unofficial Answers

N85

Answer 4 (10 points)

a. Since recipients of negative accounts receivable confirmations are requested to respond only if they disagree with the information in the confirmation, no additional audit procedures are necessary on nonresponses to negative accounts receivable confirmations.

For nonresponses to positive confirmations. Wright should consider performing the following alternative audit procedures:

- The use of other means, e.g., telephone inquiry, of directly communicating with the debtor.
- Examination of evidence of subsequent cash receipts.
- Examination of evidence of customer orders, duplicate sales invoices, and shipping documents.
- Examination of William's files involving correspondence with the customers.

b. The other matters that Wright would expect to be included in William's management representation letter are whether or not

- Management acknowledges responsibility for the fair presentation in the financial statements of financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles (or other comprehensive basis of accounting).
- All financial records and data were made available.
- The accountant has been furnished with copies of all minutes of meetings of stockholders, board of directors, and committees of the board of directors (or other similar bodies).
- The company has satisfactory title to all owned assets, and whether there are liens or encumbrances on such assets or any pledging of assets.
- Provision, when material, has been made to reduce excess or obsolete inventories to their estimated net realizable value.
- There are related party transactions or related party receivables or payables that have not been properly disclosed in the financial statements.
- There are compensating balance or other arrangements involving restrictions on cash balances.
- Unasserted claims or assessments that management's counsel has advised are probable of assertion have been disclosed in accordance with Statement of Financial Accounting Standards No. 5.
- There are other material liabilities or gain or loss contingencies that are required to be accrued or disclosed.

M85

Answer 4 (10 points)

a. Evidence found in the working papers to support the fact that the audit was adequately planned and assistants were properly supervised would be

- Documentation indicating discussions with client personnel concerning developments affecting the entity that require recognition in the audit plan.
- Documentation of a preaudit planning conference among audit firm personnel to develop an audit strategy by considering matters noted in the review of prior years' working papers, changes in accounting and auditing standards, etc.
- An internal control writeup documenting that the system of internal accounting control had been reviewed.
- Audit programs tailored to the strengths and weaknesses of the internal accounting control system.
- Audit programs indicating steps that were assigned to and completed by individual assistants.
- A budget indicating the time to be spent in each audit area.
- Individual working papers signed by reviewers to document review, approval, and responsibility.
- All questions raised by assistants were answered.

b. Substantive tests which would document management's completeness assertion as it relates to inventory quantities would be

- Observation of physical inventory counts.
- Analytical review of the relationship of inventory balances to purchase, production, and sales activities.
- Inspection of shipping and receiving documentation for proper amounts and dates to verify proper cutoff procedures.
- Obtaining confirmation of inventories at locations outside the entity.
- Tracing test counts recorded during the physical inventory observation to the inventory listing.
- Accounting for all inventory tags and count sheets used in recording the physical inventory counts.
- Recomputing the inventory calculations for clerical accuracy.
- Reconciling physical counts to perpetual records and general ledger balances and investigating significant differences.

B. Specific Audit Objectives and Procedures

M89

Answer 4 (10 points)

Edwards should consider applying the following additional substantive audit procedures:

- Test the accuracy of the aged accounts receivable schedule.
- Send second requests for all unanswered positive confirmation requests.
- Perform alternative auditing procedures for unanswered second confirmation requests.
- Reconcile and investigate exceptions reported on the confirmations.

Auditing

- Project the results of the sample confirmation procedures to the population and evaluate the confirmation results.
- Determine whether any accounts receivable are owed by employees or related parties.
- Test the cut-off of sales, cash receipts, and sales returns and allowances.
- Evaluate the reasonableness of the allowance for doubtful accounts.
- Perform analytical procedures for accounts receivable (e.g., accounts receivable to credit sales, allowance for doubtful accounts to accounts receivable, sales to returns and allowances, doubtful accounts expense to net credit sales).
- Identify differences, if any, between the book and tax basis for the allowance for doubtful accounts and related expense.
- Review activity after the balance sheet date for unusual transactions.
- Determine that the presentation and disclosure of accounts receivable is in conformity with generally accepted accounting principles consistently applied.

M88

Answer 3 (10 points)

The substantive audit procedures that Young should apply when testing for loss contingencies relating to litigation, claims, and assessments include the following:

- Read minutes of meetings of stockholders, directors, and committees.
- Read contracts, loan agreements, leases, and other documents.
- Read correspondence with taxing and other governmental agencies.
- Read correspondence with insurance and bonding companies.
- Read confirmation replies for information concerning guarantees.
- Discuss with management the entity's policies and procedures for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtain from management or inside general counsel a description and evaluation of litigation, claims, and assessments.
- Obtain written assurance from management that the financial statements include all accruals and disclosures required by Statement on Financial Accounting Standards No. 5.
- Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence from lawyers.
- Obtain an analysis of professional fee expenses and review supporting invoices for indications of contingencies.
- Request the client's management to prepare for transmittal a letter of inquiry to those lawyers consulted by the client concerning litigation, claims, and assessments.

- Compare the lawyer's response to the items in the letter of inquiry to the description and evaluation of litigation, claims, and assessments obtained from management.
- Determine that the financial statements include proper accruals and disclosures of the contingencies.

N87

Answer 3 (10 points)

The auditor should

- Review answers to questions on confirmation requests to determine proper recognition in accounting records and the necessity for financial statement disclosure.
- Make inquiries as to compensating balances and restrictions.
- Obtain copies of the bank reconciliations as of the balance sheet date, and
 - Trace the adjusted book balances to the general ledger balances.
 - Compare the bank balances to the opening balances on the cut-off bank statements.
 - Compare the bank balances to the balances on the confirmations.
 - Trace amounts of deposits in transit to the cut-off bank statements and ascertain whether the time lags are reasonable.
 - Verify the clerical accuracy of the reconciliations.
 - Obtain explanation for unusual reconciling items, including checks drawn to "bearer," "cash," and related parties.
 - Trace checks dated prior to the end of the period that were returned with the cut-off statements to the list of outstanding checks.
 - Investigate outstanding checks that did not clear with the cut-off bank statements.
 - Examine a sample of checks for payee, amount, date, authorized signatures, and endorsements to determine any irregularities from company policy or accounting records.
- Prepare a bank transfer schedule from a review of the cash receipts and disbursements journals, bank statements, and related paid checks for the last few days before and the first few days after the year-end, and
 - Review the schedule to determine that the deposit and disbursement of each transfer is recorded in the proper period.
 - Trace incomplete transfers to the schedule of outstanding checks and deposits in transit.

M86

Answer 2 (10 points)

The substantive audit procedures that Jones should apply in examining the common stock and treasury stock accounts are as follows:

Unofficial Answers

- Review the corporate charter to verify details of the common stock such as authorized shares, par value, etc.
 - Obtain or prepare an analysis of changes in common stock and treasury stock accounts.
 - Compare opening balances with prior year's working papers.
 - Foot the total shares outstanding in the stockholders' ledger and stock certificate book.
 - Determine authorization for common stock issuances and treasury stock transactions by inspecting the minutes of the Board of Directors' meetings.
 - Verify capital stock issuances by examining supporting documentation and tracing entries into the records.
 - Verify treasury stock transactions by examining supporting documentation and tracing entries into the records.
 - Examine all certificates canceled during the year.
 - Inspect all treasury stock certificates owned by the client.
 - Reconcile the details of the individual certificates in the stock certificate book with the individual shareholders' accounts in the stockholders' ledger.
 - Compare the totals in the stockholders' ledger and the stock certificate book to the balance sheet presentation.
 - Recompute the weighted average number of shares outstanding.
 - Compare the financial statement presentation and disclosure with generally accepted accounting principles.
 - Determine the existence of and proper accounting for common stock and treasury stock transactions occurring since year-end.
 - Obtain written representations concerning common and treasury stock in the client representation letter.
- N85**
Answer 2 (10 points)
- a. In order for May & Marty to satisfy itself about the independence and professional reputation of Dey & Dee and assure itself that there has been coordination of activities between the two auditors in order to achieve a proper review of matters affecting consolidation, May & Marty, whether or not it makes reference to Dey & Dee's examination, should consider performing the following procedures:
- Make inquiries about the professional reputation and standing of Dey & Dee to one or more of the following:
 - AICPA, applicable state society of CPAs, and/or local chapter.
 - Other appropriate sources such as other practitioners, bankers, and other credit grantors.
 - Obtain a representation from Dey & Dee that it is independent under the requirements of the AICPA and, if appropriate, the requirements of the SEC.
 - Ascertain through communication with Dey & Dee that
 - Dey & Dee is aware that the BGI-Western financial statements are to be included in the BGI consolidated financial statements on which May & Marty will report, and that Dey & Dee's report will be relied upon by May & Marty.
 - Dey & Dee is familiar with GAAP and GAAS and will conduct its examination in accordance therewith.
 - Dey & Dee has knowledge of the relevant financial reporting requirements for statements and schedules to be filed with regulatory agencies such as the SEC, if appropriate.
 - A review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among components included in the financial statements.
- b. May & Marty could adopt the position of not making reference to Dey & Dee's examination of BGI-Western if May & Marty is able to satisfy itself about the independence and professional reputation of Dey & Dee and takes steps it considers appropriate to satisfy itself as to Dey & Dee's examination of BGI-Western. Ordinarily, May & Marty would be able to adopt the position of not making reference to Dey & Dee's examination when any one of the following conditions exists:
- Dey & Dee is an associate or correspondent firm and its work is acceptable to May & Marty based on May & Marty's knowledge of the professional standards and competence of Dey & Dee; or
 - Dey & Dee is retained by May & Marty and the work is performed under May & Marty's guidance and control; or
 - May & Marty takes steps it considers necessary to satisfy itself as to Dey & Dee's examination. Such steps may include a visit to Dey & Dee to discuss

Auditing

Dey & Dee's audit procedures or a review of Dey & Dee's audit programs and/or working papers. In addition, May & Marty is satisfied about the reasonableness of the statements of BGI-Western for purposes of inclusion in BGI's consolidated financial statements; or

- BGI-Western's financial statements are not a material part of BGI's consolidated financial statements.

C. Other Specific Audit Topics

N88

Answer 2 (10 points)

The audit procedures Temple should apply to identify Ford's related party relationships and transactions include the following:

- Evaluate the company's procedures for identifying and properly reporting related party relationships and transactions.
- Request from management the names of all related parties and inquire whether there were any transactions with these parties during the period.
- Review tax returns and filings with other regulatory agencies for the names of related parties.
- Determine the names of all pension plans and other trusts and the names of their officers and trustees.
- Review stock certificate book to identify the stockholders.
- Review material investment transactions to determine whether the investments created related party relationships.
- Review the minutes of board of directors' meetings.
- Review conflict-of-interest statements obtained by the company from its management.
- Review the extent and nature of business transacted with major customers, suppliers, borrowers, and lenders.
- Consider whether transactions are occurring, but are not being given proper accounting recognition, e.g. personal use of company vehicles, interest-free loans, etc.
- Review accounting records for large, unusual, or nonrecurring transactions or balances, paying particular attention to transactions recognized at or near the end of the reporting period.
- Review confirmations of compensating balance arrangements for indications that balances are or were maintained for or by related parties.

- Review invoices from law firms that have performed services for the company for indications of the existence of related party relationships or transactions.
- Review confirmations of loans receivable and payable for indications of guarantees, and determine their nature and the relationships, if any, of the guarantors to the reporting entity.

N87

Answer 4 (10 points)

The potential benefits to an auditor of using microcomputer software in an audit as compared to performing an audit without the use of a computer include the following:

1. Time may be saved by eliminating manual footing, cross-footing, and other routine calculations.
2. Calculations, comparisons, and other data manipulations are more accurately performed.
3. Analytical review calculations may be more efficiently performed.
4. The scope of analytical review procedures may be broadened.
5. Audit sampling may be facilitated.
6. Potential weaknesses in a client's internal accounting control system may be more readily identified.
7. Preparation and revision of flowcharts depicting the flow of financial transactions in a client's system may be facilitated.
8. Working papers may be easily stored and accessed.
9. Graphics capabilities may allow the auditor to generate, display, and evaluate various financial and nonfinancial relationships graphically.
10. Engagement-management information such as time budgets and the monitoring of actual time vs. budgeted amounts may be more easily generated and analyzed.
11. Customized working papers may be developed with greater ease.
12. Standardized audit correspondence such as engagement letters, client representation letters, and attorney letters may be stored and easily modified.
13. Supervisory-review time may be reduced.
14. Staff morale and productivity may be improved by reducing the time spent on clerical tasks.
15. Client's personnel may not need to manually prepare as many schedules and otherwise spend as much time assisting the auditor.
16. Computer-generated working papers are generally more legible and consistent.

Unofficial Answers

M87

Answer 3 (10 points)

a. The advantages of PPS sampling over classical variables sampling are as follows:

- PPS sampling is generally easier to use than classical variables sampling.
- Size of a PPS sample is not based on the estimated variation of audited amounts.
- PPS sampling automatically results in a stratified sample.
- Individually significant items are automatically identified.
- If no errors are expected, PPS sampling will usually result in a smaller sample size than classical variables sampling.
- A PPS sample can be easily designed and sample selection can begin before the complete population is available.

$$\text{b. Sampling Interval} = \frac{\text{Tolerable Error}}{\text{Reliability Factor for Errors of Overstatement}}$$

$$= \frac{\$15,000}{\$ 3.00}$$

$$= \underline{\underline{\$5,000}}$$

$$\text{Sample Size} = \frac{\text{Recorded Amount}}{\text{Sampling Interval}}$$

$$= \frac{\$300,000}{\$5,000}$$

$$= \underline{\underline{60}}$$

c.

	<u>Recorded Amount</u>	<u>Audit Amount</u>	<u>Tainting</u>	<u>Sampling Interval</u>	<u>Projected Error</u>
1st error	\$ 400	\$ 320	20%	\$1,000	\$ 200
2nd error	500	0	100%	1,000	1,000
3rd error	3,000	2,500	*	1,000	500
Total Projected Error					<u>\$1,700</u>

* The recorded amount is greater than the sampling interval; therefore, the projected error equals the actual error.

M86

Answer 5 (10 points)

The remaining steps are as follows:

6. Treat the individually significant items as a separate population.
7. Choose an audit sampling technique.
8. Determine the sample size, giving consideration for —
 - a. Variations within the population.
 - b. Acceptable level of risk.
 - c. Tolerable error.

d. Expected amount of error.

e. Population size.

9. Determine the method of selecting a representative sample.
10. Select the sample items.
11. Apply appropriate audit procedures to the sample items.
12. Evaluate the sample results.
 - a. Project the error to the population and consider sampling risk.

Auditing

- b. Consider the qualitative aspects of errors and reach an overall conclusion.

13. Document the sampling procedure.

M85

Answer 5 (10 points)

a. The auditor's justification for accepting the uncertainties that are inherent in the sampling process are based upon the premise that the

- Cost of examining all of the financial data would usually outweigh the benefit of the added reliability of a complete (100%) examination.
- Time required to examine all of the financial data would usually preclude issuance of a timely auditor's report.

b. The uncertainties inherent in applying auditing procedures are collectively referred to as ultimate audit risk. Ultimate audit risk, with respect to a particular account balance or class of transactions, is the risk that there is a monetary error greater than tolerable error in the balance or class that the auditor fails to detect. Ultimate audit risk is a combination of three types of risks as follows:

- *Inherent risk* is the risk that errors will occur in the accounting system.
- *Control risk* is the risk that material errors will not be detected by the client's system of internal accounting control.
- *Detection risk* is the risk that any material errors that occur will not be detected by the auditor.

Ultimate audit risk includes both uncertainties due to sampling and uncertainties due to factors other than sampling. These aspects of ultimate audit risk are referred to as sampling risk and nonsampling risk, respectively.

c. Sampling risk arises from the possibility that, when a compliance or a substantive test is restricted to a sample, the auditor's conclusions may be different from the conclusions that might be reached if the test were applied in the same way to all items in the account balance or class of transactions. That is, a particular

sample may contain proportionately more or less monetary errors or compliance deviations than exist in the balance or class as a whole.

Nonsampling risk includes all the aspects of ultimate audit risk that are not due to sampling. An auditor may apply a procedure to all transactions or balances and still fail to detect a material misstatement or a material internal accounting control weakness. Nonsampling risk includes the possibility of selecting audit procedures that are not appropriate to achieve the specific objective, or failing to recognize errors in documents examined, which would render the procedure ineffective even if all items were examined.

The auditor should apply professional judgment in assessing sampling risk. In performing substantive tests of details the auditor is concerned with two aspects of sampling risk:

- *The risk of incorrect acceptance* is the risk that the sample supports the conclusion that the recorded account balance is not materially misstated when it is materially misstated.
- *The risk of incorrect rejection* is the risk that the sample supports the conclusion that the recorded account balance is materially misstated when it is not materially misstated.

The auditor is also concerned with two aspects of sampling risk in performing compliance tests of internal accounting control:

- *The risk of overreliance* on internal accounting control is the risk that the sample supports the auditor's planned degree of reliance on the control when the true compliance rate does not justify such reliance.
- *The risk of underreliance* on internal accounting control is the risk that the sample does not support the auditor's planned degree of reliance on the control when the true compliance rate supports such reliance.

The risk of incorrect acceptance and the risk of overreliance on internal accounting control relate to the effectiveness of an audit in detecting an existing material misstatement. The risk of incorrect rejection and the risk of underreliance on internal accounting control relate to the efficiency of the audit.

Unofficial Answers

IV. Reporting

A. Reporting Standards and Types of Reports

M89

Answer 2 (10 points)

The auditor's report contains the following deficiencies:

Opening (introductory) paragraph

1. All the financial statements audited are not identified.
2. Management's responsibility for the financial statements is omitted.

Scope paragraph

3. Reference to "generally accepted auditing standards" is omitted.
4. An auditor obtains reasonable assurance about whether the financial statements are "free of material misstatement," not "in conformity with generally accepted accounting principles."
5. The statement that an audit includes "evaluating the overall financial statement presentation" is omitted.
6. The statement that the auditors "believe that our audit provides a reasonable basis for our opinion" is omitted.

Explanatory paragraph

7. The explanatory paragraph should follow the opinion paragraph.
8. The auditors should not give an opinion concerning the entity's survival "beyond a reasonable period of time."

Opinion paragraph

9. A qualified ("subject to") opinion is inappropriate.
10. The date of the financial statements audited is omitted.
11. There should be no reference to consistency unless the accounting principles have not been applied consistently.

N88

Answer 4 (10 points)

Deficiencies in the staff assistant's draft are as follows:

Within the first paragraph

- The statement of cash flow is not identified.
- Standards established by the AICPA, not generally accepted auditing standards, should be referred to.
- The financial statements are not stated to be the representations of management.
- The phrase "our review included such tests of the accounting records as we considered necessary in the circumstances" is inappropriate.

Within the second paragraph

- The phrase "analytical procedures applied to financial data" is omitted.
- The phrase "more in scope than a compilation" is inappropriate.
- An opinion should be disclaimed.
- "Limited assurance" should not be expressed.

Within the third paragraph

- Reference to the "exception" in the third paragraph when it has been restated is inappropriate.
- Reference to consistency is inappropriate.

Within the fourth paragraph

- There should be reference to the prior year's review report.
- There should be reference to generally accepted accounting principles.

M88

Answer 2

b. The accountant's standard report on a compilation of a financial projection should include

- An identification of the projection presented by the responsible party.
- A statement that the accountant has compiled the projection in accordance with standards established by the AICPA.
- A separate paragraph that describes the limitations on the use of the presentation.
- A statement that a compilation is limited in scope and does not enable the accountant to express an opinion or any other form of assurance on the projection or the assumptions.

Auditing

- A caveat that the prospective results may not be achieved.
- A statement that the accountant assumes no responsibility to update the report for events and circumstances occurring after the date of the report.

M87

Answer 2 (10 points)

Deficiencies in the staff assistant's draft are as follows:

Within the first paragraph

- The financial statements are not identified by proper names.
- There should be reference to standards established by the AICPA, not Statements on Standards for Auditing and Review Services.
- There is failure to state that the financial statements are the representations of management.

Within the second paragraph

- There is omission of reference to inquiries of company personnel.
- It is inappropriate to state that a review is more in scope than a compilation.
- There is failure to disclaim an opinion.

Within the third paragraph

- Reference should not be made to compilation of the 1985 financial statements.
- The reference to "material modifications" should apply to the 1986 financial statements only, and not to the 1985 financial statements.
- Reference to consistency with the prior year's financial statements should be omitted.
- There is failure to refer to conformity with generally accepted accounting principles.

Within the fourth paragraph

- There is failure to state that a compilation is limited to presenting in the form of financial statements information that is the representation of management.
- There is failure to state that the 1985 financial statements were not audited or reviewed.
- There is omission of proper reference to "any other form of assurance" on the 1985 financial statements.

B. Other Reporting Considerations

N85

Answer 2 (10 points)

a. In order for May & Marty to satisfy itself about the independence and professional reputation of Dey & Dee and assure itself that there has been coordination of activities between the two auditors in order to achieve a proper review of matters affecting consolidation, May & Marty, whether or not it makes reference to Dey & Dee's examination, should consider performing the following procedures:

- Make inquiries about the professional reputation and standing of Dey & Dee to one or more of the following:

- AICPA, applicable state society of CPAs, and/or local chapter.
- Other appropriate sources such as other practitioners, bankers, and other credit grantors.

- Obtain a representation from Dey & Dee that it is independent under the requirements of the AICPA and, if appropriate, the requirements of the SEC.
- Ascertain through communication with Dey & Dee that

- Dey & Dee is aware that the BGI-Western financial statements are to be included in the BGI consolidated financial statements on which May & Marty will report, and that Dey & Dee's report will be relied upon by May & Marty.
- Dey & Dee is familiar with GAAP and GAAS and will conduct its examination in accordance therewith.
- Dey & Dee has knowledge of the relevant financial reporting requirements for statements and schedules to be filed with regulatory agencies such as the SEC, if appropriate.
- A review will be made of matters affecting elimination of intercompany transactions and accounts and, if appropriate in the circumstances, the uniformity of accounting practices among components included in the financial statements.

b. May & Marty could adopt the position of not making reference to Dey & Dee's examination of BGI-Western if May & Marty is able to satisfy itself about the independence and professional reputation of Dey & Dee and takes steps it considers appropriate to satisfy itself as to Dey & Dee's examination of BGI-Western. Ordinarily, May & Marty would be able to adopt the position of not making reference to Dey & Dee's examination when any one of the following conditions exists:

- Dey & Dee is an associate or correspondent firm and its work is acceptable to May & Marty based on May & Marty's knowledge of the professional standards and competence of Dey & Dee; or
- Dey & Dee is retained by May & Marty and the work is performed under May & Marty's guidance and control; or
- May & Marty takes steps it considers necessary to satisfy itself as to Dey & Dee's examination. Such steps may include a visit to Dey & Dee to discuss Dey & Dee's audit procedures or a review of Dey & Dee's audit programs and/or working papers. In addition, May & Marty is satisfied about the reasonableness of the statements of BGI-Western for purposes of inclusion in BGI's consolidated financial statements; or
- BGI-Western's financial statements are not a material part of BGI's consolidated financial statements.

Uniform CPA Examination/May 1985 – May 1989

Business Law

**Selected Questions
And Unofficial Answers
Indexed To
Content Specification
Outline**

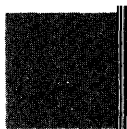


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MULTIPLE CHOICE ITEMS — SELECTED QUESTIONS

I. The CPA and the Law

A. Common Law Liability to Clients and Third Persons

M89#1. Krim, President and CEO of United Co., engaged Smith, CPA, to audit United's financial statements so that United could secure a loan from First Bank. Smith issued an unqualified opinion on May 20, 1988, but the loan was delayed. On August 5, 1988, on inquiry to Smith by First Bank, Smith, relying on Krim's representation, made assurances that there was no material change in United's financial status. Krim's representation was untrue because of a material change which took place after May 20, 1988. First relied on Smith's assurances of no change. Shortly thereafter, United became insolvent. If First sues Smith for negligent misrepresentation, Smith will be found

- a. Not liable, because Krim misled Smith, and a CPA is **not** responsible for a client's untrue representations.
- b. Liable, because Smith should have undertaken sufficient auditing procedures to verify the status of United.
- c. Not liable, because Smith's opinion only covers the period up to May 20.
- d. Liable, because Smith should have contacted the chief financial officer rather than the chief executive officer.

M89#2. If a stockholder sues a CPA for common law fraud based on false statements contained in the financial statements audited by the CPA, which of the following, if present, would be the CPA's best defense?

- a. The stockholder lacks privity to sue.
- b. The false statements were immaterial.
- c. The CPA did **not** financially benefit from the alleged fraud.
- d. The contributory negligence of the client.

M89#6. When CPAs fail in their duty to carry out their contracts for services, liability to clients may be based on

	<u>Breach of contract</u>	<u>Strict liability</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

M89#7. Which one of the following, if present, would support a finding of constructive fraud on the part of a CPA?

- a. Privity of contract.
- b. Intent to deceive.
- c. Reckless disregard.
- d. Ordinary negligence.

M89#9. Nast Corp. orally engaged Baker & Co., CPAs, to audit its financial statements. The management of Nast informed Baker that it suspected the accounts receivable were materially overstated. Although the financial statements audited by Baker did, in fact, include a materially overstated accounts receivable balance, Baker issued an unqualified opinion. Nast relied on the financial statements in deciding to obtain a loan from Century Bank to expand its operations. Nast has defaulted on the loan and has incurred a substantial loss.

If Nast sues Baker for negligence in failing to discover the overstatement, Baker's best defense would be that

- a. Baker did **not** perform the audit recklessly or with an intent to deceive.
- b. Baker was **not** in privity of contract with Nast.
- c. The audit was performed by Baker in accordance with generally accepted auditing standards.
- d. No engagement letter had been signed by Baker.

M88

Items 1 and 2 are based on the following information:

Mead Corp. orally engaged Dex & Co., CPAs, to audit its financial statements. The management of Mead informed Dex that it suspected that the accounts receivable were materially overstated. Although the financial statements audited by Dex did, in fact, include a materially overstated accounts receivable balance, Dex issued an unqualified opinion. Mead relied on the financial statements in deciding to obtain a loan from City Bank to expand its operations. City relied on the financial statements in making the loan to Mead. As a

Business Law

result of the overstated accounts receivable balance, Mead has defaulted on the loan and has incurred a substantial loss.

1. If Mead sues Dex for negligence in failing to discover the overstatement, Dex's best defense would be that

- a. No engagement letter had been signed by Dex.
- b. The audit was performed by Dex in accordance with generally accepted auditing standards.
- c. Dex was **not** in privity of contract with Mead.
- d. Dex did **not** perform the audit recklessly or with an intent to deceive.

2. If City sues Dex for fraud, Dex would most likely avoid liability if it could prove that

- a. Dex was **not** in privity of contract with City.
- b. Dex did **not** perform the audit recklessly or with an intent to deceive.
- c. Mead should have provided more specific information concerning its suspicions.
- d. Mead was contributorily negligent.

N87

Items 26 and 27 are based on the following information:

Brown & Co., CPAs, issued an unqualified opinion on the financial statements of its client, King Corp. Based on the strength of King's financial statements, Safe Bank loaned King \$500,000. Brown was unaware that Safe would receive a copy of the financial statements or that they would be used in obtaining a loan by King. King defaulted on the loan.

26. If Safe commences an action for negligence against Brown, and Brown is able to prove that it conducted the audit in conformity with GAAS, Brown will

- a. Be liable to Safe because Safe relied on the financial statements.
- b. Be liable to Safe because the statute of frauds has been satisfied.
- c. Not be liable to Safe because there is a conclusive presumption that following GAAS is the equivalent of acting reasonably and with due care.
- d. Not be liable to Safe because there was a lack of privity of contract.

27. If Safe commences an action for common law fraud against Brown, then to be successful, Safe must prove in addition to other elements that it

- a. Was in privity of contract with Brown.
- b. Was **not** contributorily negligent.
- c. Was in privity of contract with King.
- d. Justifiably relied on the financial statements.

N87#28. One of the elements necessary to hold a CPA liable to a client for conducting an audit negligently is that the CPA

- a. Acted with scienter or guilty knowledge.
- b. Was a fiduciary of the client.
- c. Failed to exercise due care.
- d. Executed an engagement letter.

N87#29. In general, the third party (primary) beneficiary rule as applied to a CPA's legal liability in conducting an audit is relevant to which of the following causes of action against a CPA?

	<u>Fraud</u>	<u>Constructive fraud</u>	<u>Negligence</u>
a.	Yes	Yes	No
b.	Yes	No	No
c.	No	Yes	Yes
d.	No	No	Yes

N87#30. If a CPA recklessly departs from the standards of due care when conducting an audit, the CPA will be liable to third parties who were unknown to the CPA based on

- a. Strict liability.
- b. Gross negligence.
- c. Negligence.
- d. Breach of contract.

N86#1. Starr Corp. approved a plan of merger with Silo Corp. One of the determining factors in approving the merger was the strong financial statements of Silo which were audited by Cox & Co., CPAs. Starr had engaged Cox to audit Silo's financial statements. While performing the audit, Cox failed to discover certain irregularities which have subsequently caused Starr to suffer substantial losses. In order for Cox to be liable under common law, Starr at a minimum must prove that Cox

- a. Acted recklessly or with a lack of reasonable grounds for belief.
- b. Knew of the irregularities.
- c. Failed to exercise due care.
- d. Was grossly negligent.

N86#2. In which of the following statements concerning a CPA firm's action is scienter or its equivalent absent?

- a. Actual knowledge of fraud.
- b. Performance of substandard auditing procedures.
- c. Reckless disregard for the truth.
- d. Intent to gain monetarily by concealing fraud.

Selected Questions

N86#4. Ritz Corp. wished to acquire the stock of Stale, Inc. In conjunction with its plan of acquisition Ritz hired Fein, CPA, to audit the financial statements of Stale. Based on the audited financial statements and Fein's unqualified opinion, Ritz acquired Stale. Within six months, it was discovered that the inventory of Stale had been overstated by \$500,000. Ritz commenced an action against Fein. Ritz believes that Fein failed to exercise the knowledge, skill, and judgment commonly possessed by CPAs in the locality, but is not able to prove that Fein either intentionally deceived it or showed a reckless disregard for the truth. Ritz also is unable to prove that Fein had any knowledge that the inventory was overstated. Which of the following two causes of action would provide Ritz with proper bases upon which Ritz would most likely prevail?

- a. Negligence and breach of contract.
- b. Negligence and gross negligence.
- c. Negligence and fraud.
- d. Gross negligence and breach of contract.

N86#5. In a common law action against an accountant, the lack of privity is a viable defense if the plaintiff

- a. Is a creditor of the client who sues the accountant for negligence.
- b. Can prove the presence of gross negligence which amounts to a reckless disregard for the truth.
- c. Is the accountant's client.
- d. Bases his action upon fraud.

B. Federal Statutory Liability

M89#3. Tax preparers who aid and abet federal tax evasion are subject to

	<u>Injunction to be prohibited from acting as tax preparers</u>	<u>General federal criminal prosecution</u>
a.	No	No
b.	Yes	No
c.	No	Yes
d.	Yes	Yes

M89#4. Brown, CPA, helped Cook organize a partnership that was actually an abusive tax shelter. Brown induced clients to participate by making false statements concerning the allowability of deductions and tax credits. As a result of these activities, Cook derived \$100,000 gross income and Brown derived \$50,000 gross income. What is Brown's federal statutory liability under the provision of the Internal Revenue Code specifically relating to promoting abusive tax shelters?

- a. \$ 10,000
- b. \$ 30,000
- c. \$ 50,000
- d. \$150,000

M89#8. Burt, CPA, issued an unqualified opinion on the financial statements of Midwest Corp. These financial statements were included in Midwest's annual report and Form 10-K filed with the SEC. As a result of Burt's reckless disregard for GAAS, material misstatements in the financial statements were not detected. Subsequently, Davis purchased stock in Midwest in the secondary market without ever seeing Midwest's annual report or Form 10-K. Shortly thereafter, Midwest became insolvent and the price of the stock declined drastically. Davis sued Burt for damages based on Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. Burt's best defense is that

- a. There has been no subsequent sale for which a loss can be computed.
- b. Davis did not purchase the stock as part of an initial offering.
- c. Davis did not rely on the financial statements or Form 10-K.
- d. Davis was not in privity with Burt.

M89#10. Gold, CPA, rendered an unqualified opinion on the 1987 financial statements of Eastern Power Co. Egan purchased Eastern bonds in a public offering subject to the Securities Act of 1933. The registration statement filed with the SEC included the financial statements. Gold is being sued by Egan under Section 11 of the Securities Act of 1933 for the misstatements contained in the financial statements. To prevail, Egan must prove

	<u>Scienter</u>	<u>Reliance</u>
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

M88#8. West & Co., CPAs, was engaged by Sand Corp. to audit its financial statements. West issued an unqualified opinion on Sand's financial statements. Sand has been accused of making negligent misrepresentations in the financial statements, which Reed relied upon when purchasing Sand stock. West was not aware of the misrepresentations nor was it negligent in performing the audit. If Reed sues West for damages based upon Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934, West will

- a. Lose, because Reed relied upon the financial statements.
- b. Lose, because the statements contained negligent misrepresentations.
- c. Prevail, because some element of scienter must be proved.
- d. Prevail, because Reed was not in privity of contract with West.

M88#9. In general, if the IRS issues a 30-day letter to an individual taxpayer who wishes to dispute the assessment, the taxpayer

- a. May, without paying any tax, immediately file a petition that would properly commence an action in Tax Court.
- b. May ignore the 30-day letter and wait to receive a 90-day letter.
- c. Must file a written protest within 10 days of receiving the letter.
- d. Must pay the taxes and then commence an action in federal district court.

N87

Items 31 and 32 are based on the following information:

West & Co., CPAs, rendered an unqualified opinion on the financial statements of Pride Corp., which were included in Pride's registration statement filed with the SEC. Subsequently, Hex purchased 500 shares of Pride's preferred stock, which were acquired as part of a public offering subject to the Securities Act of 1933. Hex has commenced an action against West based on the Securities Act of 1933 for losses resulting from misstatements of facts in the financial statements included in the registration statement.

31. Which of the following elements must Hex prove to hold West liable?

- a. West rendered its opinion with knowledge of material misstatements.
- b. West performed the audit negligently.
- c. Hex relied on the financial statements included in the registration statement.
- d. The misstatements were material.

32. Which of the following defenses would be **least** helpful to West in avoiding liability to Hex?

- a. West was **not** in privity of contract with Hex.
- b. West conducted the audit in accordance with GAAS.
- c. Hex's losses were caused by factors other than the misstatements.
- d. Hex knew of the misstatements when Hex acquired the preferred stock.

N87#33. In preparing Watt's 1986 individual income tax return, Stark, CPA, took a deduction contrary to a Tax Court decision that had disallowed a similar deduction. Stark's position was adopted in good faith and with a reasonable belief that the Tax Court decision failed to conform to the Internal Revenue Code. Under the circumstances, Stark will

- a. Not be liable for a preparer penalty unless the understatement of taxes is at least 25% of Watt's tax liability.
- b. Not be liable for a preparer penalty if Stark exercised due diligence.
- c. Be liable for the preparer's negligence penalty.
- d. Be liable for the preparer's penalty because of Stark's intentional disregard of the Tax Court decision.

N87#34. In preparing Tint's 1986 individual income tax return, Boe, CPA, took a \$3,000 deduction for unreimbursed travel and entertainment expenses, which Tint stated he paid in 1986. Boe has no reason to believe that documentation of the travel and entertainment expenses is inadequate or non-existent. In order to avoid the preparer's negligence penalty, Boe

- a. May rely solely on Tint's statement as to the amount of the deduction.
- b. Must be advised by Tint that the documentation exists.
- c. Must examine the documentation.
- d. Must maintain copies of the documentation in its file.

N86#7. On July 1, 1986, Kent purchased common stock of Salem Corp. in an offering subject to the Securities Act of 1933. Mane & Co., CPAs, rendered an unqualified opinion on the financial statements of Salem which were included in Salem's registration statement filed with the SEC on March 1, 1986. Kent has commenced an action against Mane based on the Securities Act of 1933 provisions dealing with omissions of facts required to be stated in the registration statement. Which of the following elements of a cause of action under the Securities Act of 1933 must be proved by Kent?

- a. Kent relied upon Mane's opinion.
- b. Kent was the initial purchaser of the stock and gave value for it.
- c. Mane's omission was material.
- d. Mane acted negligently or fraudulently.

N86#8. Lee, CPA, prepared Sly's 1985 federal income tax return. Sly gave Lee a list of purported 1985 contributions to various recognized charities, totaling \$18,000. In fact, Sly had actually contributed only \$2,000 to charities during 1985. Based on Sly's list, Lee deducted \$18,000 for contributions in Sly's 1985 return, resulting in a tax understatement of about \$8,000. Sly's total tax liability shown on the return was \$65,000. Lee had no reason to doubt the accuracy of Sly's figures, although Lee did not request supporting documentation. In connection with Lee's preparation of Sly's 1985 return, Lee is subject to

- a. An automatic IRS penalty of \$100.
- b. An automatic IRS penalty of \$500.
- c. A 5% negligence penalty.
- d. No IRS penalty.

C. Workpapers, Privileged Communication, and Confidentiality

M89#5. A CPA is permitted to disclose confidential client information without the consent of the client to

- I. Another CPA who has purchased the CPA's tax practice.
- II. A successor CPA firm if the information concerns suspected tax return irregularities.

Selected Questions

III. A voluntary quality control review board.

- a. I and III only.
- b. II and III only.
- c. II only.
- d. III only.

M88

Item 3 is based on the following information:

Mead Corp. orally engaged Dex & Co., CPAs, to audit its financial statements. The management of Mead informed Dex that it suspected that the accounts receivable were materially overstated. Although the financial statements audited by Dex did, in fact, include a materially overstated accounts receivable balance, Dex issued an unqualified opinion. Mead relied on the financial statements in deciding to obtain a loan from City Bank to expand its operations. City relied on the financial statements in making the loan to Mead. As a result of the overstated accounts receivable balance, Mead has defaulted on the loan and has incurred a substantial loss.

3. If City sues Dex for fraud, could Dex be compelled to furnish City with the audit working papers?

- a. No, because of the privileged communication rule, which is recognized in a majority of jurisdictions.
- b. No, because City was **not** in privity of contract with Dex.
- c. Yes, if the working papers are relevant to the action.
- d. Yes, provided that Mead does **not** object.

N87#35. If a CPA is engaged by an attorney to assist in the defense of a tax fraud case involving the attor-

ney's client, information obtained by the CPA from the client after being engaged

- a. Is **not** privileged because the matter involves a federal issue.
- b. Is **not** privileged because the majority of jurisdictions do **not** recognize an accountant-client privilege.
- c. Will be deemed privileged communications under certain circumstances.
- d. Will be deemed privileged communications provided that the CPA prepared the client's tax return.

N86#9. In general, which of the following statements is correct with respect to ownership, possession, or access to workpapers prepared by a CPA firm in connection with an audit?

- a. The workpapers may be obtained by third parties where they appear to be relevant to issues raised in litigation.
- b. The workpapers are subject to the privileged communication rule which, in a majority of jurisdictions, prevents third-party access to the workpapers.
- c. The workpapers are the property of the client after the client pays the fee.
- d. The workpapers must be retained by the CPA firm for a period of ten years.

N86#10. The accountant-client privilege is recognized

- a. Only if the action involved is in federal court.
- b. Where a state statute has been enacted creating such a privilege.
- c. By virtue of the common law in the majority of states.
- d. In the majority of states as a result of legislative enactment and court adoption.

II. Business Organizations

A. Agency

M89#11. Pell is the principal and Astor is the agent in an agency coupled with an interest. In the absence of a contractual provision relating to the duration of the agency, who has the right to terminate the agency before the interest has expired?

	<u>Pell</u>	<u>Astor</u>
a.	Yes	Yes
b.	No	Yes
c.	No	No
d.	Yes	No

M89#12. Neal, an employee of Jordan, was delivering merchandise to a customer. On the way, Neal's negligence caused a traffic accident that resulted in damages to a third party's automobile. Who is liable to the third party?

	<u>Neal</u>	<u>Jordan</u>
a.	No	No
b.	Yes	Yes
c.	Yes	No
d.	No	Yes

M89#13. Simmons, an agent for Jensen, has the express authority to sell Jensen's goods. Simmons also has the express authority to grant discounts of up to 5% of list price. Simmons sold Hemple goods with a list price of \$1,000 and granted Hemple a 10% discount. Hemple had not previously dealt with either Simmons or Jensen. Which of the following courses of action may Jensen properly take?

- Seek to void the sale to Hemple.
- Seek recovery of \$50 from Hemple only.
- Seek recovery of \$50 from Simmons only.
- Seek recovery of \$50 from either Hemple or Simmons.

N88#1. Anker wishes to give Mix power of attorney. In general, the power of attorney

- May limit Mix's authority to specific transactions.
- Must be signed by both Anker and Mix.
- Will be valid only if Mix is a licensed attorney at law.
- May continue in existence after Anker's death.

N88#2. Harris is a purchasing agent for Elkin, a sole proprietor. Harris has the express authority to place purchase orders with Elkin's suppliers. Harris typically conducts business through the mail and has very little contact with Elkin. Elkin was incapacitated by a stroke

and was declared incompetent in a judicial proceeding. Subsequently, Harris placed an order with Ajax, Inc. on behalf of Elkin. Neither Ajax nor Harris were aware of Elkin's incapacity. With regard to the contract with Ajax, Elkin (or Elkin's legal representative) will

- Not be liable because Harris was without authority to enter into the contract.
- Not be liable provided that Harris had placed orders with Ajax in the past.
- Be liable because Harris was acting within the scope of Harris' authority.
- Be liable because Ajax was unaware of Elkin's incapacity.

N88#3. Kent Corp. hired Blue as a sales representative for nine months at a salary of \$2,000 per month plus 2% of sales. Under the circumstances,

- Kent does **not** have the power to dismiss Blue during the nine-month period without cause.
- The agreement between Kent and Blue is **not** enforceable unless it is in writing and signed by Blue.
- The agreement between Kent and Blue formed an agency coupled with an interest.
- Blue is obligated to act solely in Kent's interest in matters concerning Kent's business.

M88

Items 4 and 5 are based on the following information:

Able, on behalf of Pix Corp., entered into a contract with Sky Corp., by which Sky agreed to sell computer equipment to Pix. Able disclosed to Sky that she was acting on behalf of Pix. However, Able had exceeded her actual authority by entering into the contract with Sky.

4. If Pix does **not** want to honor the contract, it will nonetheless be held liable if Sky can prove that

- Able had apparent authority to bind Pix.
- Able believed she was acting within the scope of her authority.
- Able was an employee of Pix and **not** an independent contractor.
- The agency relationship between Pix and Able was formalized in a signed writing.

5. If Pix wishes to ratify the contract with Sky, which of the following statements is correct?

- Pix must notify Sky that Pix intends to ratify the contract.
- Able must have acted reasonably and in Pix's best interest.
- Able must be a general agent of Pix.
- Pix must have knowledge of all material facts relating to the contract at the time it is ratified.

Selected Questions

M86#6. The apparent authority of a general agent for a disclosed principal will terminate without notice to third parties when the

- a. Principal dismisses the agent.
- b. Principal or agent dies.
- c. Purpose of the agency relationship has been fulfilled.
- d. Time period set forth in the agency agreement has expired.

N87

Items 23 and 24 are based on the following information:

Frey entered into a contract with Cara Corp. to purchase televisions on behalf of Lux, Inc. Lux authorized Frey to enter into the contract in Frey's name without disclosing that Frey was acting on behalf of Lux.

- 23. If Lux repudiates the contract, Cara may
 - a. Obtain specific performance, compelling Lux to perform on the contract.
 - b. Hold Frey liable on the contract whether or not Cara discovers that Lux is the principal.
 - c. Hold Frey liable on the contract but only if Cara fails to discover that Lux was the principal.
 - d. Not hold Lux liable because proof that Lux was the principal will be barred by the parol evidence rule.
- 24. If Cara repudiates the contract, which of the following statements concerning liability on the contract is **not** correct?
 - a. Frey may hold Cara liable and obtain money damages.
 - b. Frey may hold Cara liable and obtain specific performance.
 - c. Lux may hold Cara liable upon disclosing the agency relationship with Frey.
 - d. Cara will be free from liability to Lux if Frey fraudulently stated that he was acting on his own behalf.

N87#25. Dart Corp. dismissed Ritz as its general sales agent. Dart notified all of Ritz's known customers by letter. Bing Corp., a retail outlet located outside of Ritz's previously assigned sales territory, had never dealt with Ritz. However, Bing knew of Ritz as a result of various business contacts. After his dismissal, Ritz sold Bing goods, to be delivered by Dart, and received from Bing a cash deposit for 20% of the purchase price. It was not unusual for an agent in Ritz's previous position to receive cash deposits. In an action by Bing against Dart on the sales contract, Bing will

- a. Win, because Dart's notice was inadequate to terminate Ritz's apparent authority.
- b. Win, because a principal is an insurer of an agent's acts.

- c. Lose, because Ritz lacked any express or implied authority to make the contract.
- d. Lose, because Ritz's conduct constituted a fraud for which Dart is **not** liable.

M87#4. A general agent's apparent authority to bind her principal to contracts with third parties will cease without notice to those third parties when the

- a. Agent has fulfilled the purpose for which the agency relationship was created.
- b. Time set forth in the agreement creating the agency relationship has expired.
- c. Principal and agent have mutually agreed to end their relationship.
- d. Principal has received a discharge in bankruptcy under the liquidation provisions of the Bankruptcy Code.

M87#5. If an agent has, within the scope of the agency relationship, committed both negligent and intentional acts resulting in injury to third parties, the principal

- a. May be liable even if the agent's acts were unauthorized.
- b. May effectively limit its liability to those third parties if the agent has signed a disclaimer absolving the principal from liability.
- c. Will be liable under the doctrine of respondeat superior only for the intentional acts.
- d. Will **never** be criminally liable unless it actively participated in the acts.

M87#6. Starr is an agent of a disclosed principal, Maple. On May 1, Starr entered into an agreement with King Corp. on behalf of Maple that exceeded Starr's authority as Maple's agent. On May 5, King learned of Starr's lack of authority and immediately notified Maple and Starr that it was withdrawing from the May 1 agreement. On May 7, Maple ratified the May 1 agreement in its entirety. If King refuses to honor the agreement and Maple brings an action for breach of contract, Maple will

- a. Prevail since the agreement of May 1 was ratified in its entirety.
- b. Prevail since Maple's capacity as a principal was known to Starr.
- c. Lose since the May 1 agreement is void due to Starr's lack of authority.
- d. Lose since King notified Starr and Maple of its withdrawal prior to Maple's ratification.

M86#59. Borg is the vice-president of purchasing for Crater Corp. He has authority to enter into purchase contracts on behalf of Crater provided that the price under a contract does not exceed \$2 million. Dent, who is the president of Crater, is required to approve any contract that exceeds \$2 million. Borg entered into a \$2.5 million purchase contract with Shady Corp. with-

Business Law

out Dent's approval. Shady was unaware that Borg exceeded his authority. Neither party substantially changed its position in reliance on the contract. What is the most likely result of this transaction?

- a. Crater will be bound because of Borg's apparent authority.
- b. Crater will **not** be bound because Borg exceeded his authority.
- c. Crater will only be bound up to \$2 million, the amount of Borg's authority.
- d. Crater may avoid the contract since Shady has **not** relied on the contract to its detriment.

M86#60. Cox engaged Datz as her agent. It was mutually agreed that Datz would **not** disclose that he was acting as Cox's agent. Instead he was to deal with prospective customers as if he were a principal acting on his own behalf. This he did and made several contracts for Cox. Assuming Cox, Datz or the customer seeks to avoid liability on one of the contracts involved, which of the following statements is correct?

- a. Cox must ratify the Datz contracts in order to be held liable.
- b. Datz has **no** liability once he discloses that Cox was the real principal.
- c. The third party can avoid liability because he believed he was dealing with Datz as a principal.
- d. The third party may choose to hold either Datz or Cox liable.

M85#1. Wok Corp. has decided to expand the scope of its business. In this connection, it contemplates engaging several agents. Which of the following agency relationships is within the statute of frauds and thus should be contained in a signed writing?

- a. A sales agency where the agent normally will sell goods which have a value in excess of \$500.
- b. An irrevocable agency.
- c. An agency which is of indefinite duration but which is terminable upon one month's notice.
- d. An agency for the forthcoming calendar year which is entered into in mid-December of the prior year.

M85#2. Red entered into a contract with Maple on behalf of Gem, a disclosed principal. Red exceeded his authority in entering into the contract. In order for Gem to successfully ratify the contract with Maple,

- a. Gem must expressly communicate his intention to be bound.
- b. Gem must have knowledge of the relevant material facts concerning the transaction.
- c. Red must **not** have been a minor.
- d. Red must have acted reasonably and in Gem's best interest.

M85#3. An agency coupled with an interest will be created by a written agreement which provides that a(an)

- a. Borrower shall pledge securities to a lender which authorizes the lender to sell the securities and apply the proceeds to the loan in the event of default.
- b. Employee is hired for a period of two years at \$40,000 per annum plus 2% of net sales.
- c. Broker is to receive a 5% sales commission out of the proceeds of the sale of a parcel of land.
- d. Attorney is to receive 25% of a plaintiff's recovery for personal injuries.

M85#5. Ritz hired West for six months as an assistant sales manager at \$4,000 a month plus 3% of sales. Which of the following is correct?

- a. The employment agreement must be in writing and signed by the party to be charged.
- b. The agreement between Ritz and West formed an agency coupled with an interest.
- c. West must disclose any interests he has which are adverse to Ritz in matters concerning Ritz's business.
- d. West can be dismissed by Ritz during the six months only for cause.

B. Partnerships and Joint Ventures

M89#14. Rivers and Lee want to form a partnership. For the partnership agreement to be enforceable, it must be in writing if

- a. Rivers and Lee reside in different states.
- b. The agreement cannot be completed within one year from the date on which it will be entered into.
- c. Either Rivers or Lee is to contribute more than \$500 in capital.
- d. The partnership intends to buy and sell real estate.

M89#15. Cass is a general partner in Omega Company general partnership. Which of the following unauthorized acts by Cass will bind Omega?

- a. Submitting a claim against Omega to arbitration.
- b. Confessing a judgment against Omega.
- c. Selling Omega's goodwill.
- d. Leasing office space for Omega.

M89#16. Kroll, Inc., a partner in JKL Partnership, assigns its interest in the partnership to Trell, who is not made a partner. After the assignment, Trell asserts the rights to

- I. Receive Kroll's share of JKL's profits and
- II. Inspect JKL's books and records.

Selected Questions

Trell is correct as to which of the rights?

- a. I only.
- b. II only.
- c. I and II.
- d. Neither I nor II.

N88#4. In general, which of the following statements is correct with respect to a limited partnership?

- a. A limited partner has the right to obtain from the general partner(s) financial information and tax returns of the limited partnership.
- b. A limited partnership can be formed with limited liability for all partners.
- c. A limited partner may **not** also be a general partner at the same time.
- d. A limited partner may hire employees on behalf of the partnership.

M88#7. Dill was properly admitted as a partner in the ABC Partnership after purchasing Ard's partnership interest. Ard immediately withdrew from the partnership. The partnership agreement states that the partnership will continue on the withdrawal or admission of a partner. Unless the partners otherwise agree,

- a. Dill's personal liability for partnership debts incurred before Dill was admitted will be limited to Dill's interest in partnership property.
- b. Ard will automatically be released from personal liability for partnership debts incurred before Dill's admission.
- c. Ard will be permitted to recover from the other partners the full amount that Ard has paid on account of partnership debts incurred before Dill's admission.
- d. Dill will be subjected to unlimited personal liability for partnership debts incurred before being admitted.

M88#13. X, Y, and Z have capital balances of \$30,000, \$15,000, and \$5,000, respectively, in the XYZ Partnership. The general partnership agreement is silent as to the manner in which partnership losses are to be allocated but does provide that partnership profits are to be allocated as follows: 40% to X, 25% to Y, and 35% to Z. The partners have decided to dissolve and liquidate the partnership. After paying all creditors, the amount available for distribution will be \$20,000. X, Y, and Z are individually solvent. Under the circumstances, Z will

- a. Receive \$7,000.
- b. Receive \$12,000.
- c. Personally have to contribute an additional \$5,500.
- d. Personally have to contribute an additional \$5,000.

M88#14. Grey and Carr entered into a written partnership agreement to operate a hardware store. Their agreement was silent as to the duration of the partnership. Grey wishes to dissolve the partnership. Which of the following statements is correct?

- a. Unless Carr consents to a dissolution, Grey must apply to a court and obtain a decree ordering the dissolution.

- b. Grey may **not** dissolve the partnership unless Carr consents.
- c. Grey may dissolve the partnership only after notice of the proposed dissolution is given to all partnership creditors.
- d. Grey may dissolve the partnership at any time.

N87#19. In general, which of the following statements is correct with respect to a limited partnership?

- a. A limited partner will be personally liable for partnership debts incurred in the ordinary course of the partnership's business.
- b. A limited partner is unable to participate in the management of the partnership in the same manner as general partners and still retain limited liability.
- c. A limited partner's death or incompetency will cause the partnership to dissolve.
- d. A limited partner is an agent of the partnership and has the authority to bind the partnership to contracts.

N87#20. Unless otherwise provided for in the partnership agreement, the assignment of a partner's interest in a general partnership will

- a. Result in the termination of the partnership.
- b. Not affect the assigning partner's liability to third parties for obligations existing at the time of the assignment.
- c. Transfer the assigning partner's rights in specific partnership property to the assignee.
- d. Transfer the assigning partner's right to bind the partnership to contracts to the assignee.

N87#21. In the absence of a specific provision in a general partnership agreement, partnership losses will be allocated

- a. Equally among the partners irrespective of the allocation of partnership profits.
- b. In the same manner as partnership profits.
- c. In proportion to the partners' capital contributions.
- d. In proportion to the partners' capital contributions and outstanding loan balances.

N87#22. The apparent authority of a partner to bind the partnership in dealing with third parties

- a. Would permit a partner to submit a claim against the partnership to arbitration.
- b. Must be derived from the express powers and purposes contained in the partnership agreement.
- c. Will be effectively limited by a formal resolution of the partners of which third parties are aware.
- d. Will be effectively limited by a formal resolution of the partners of which third parties are unaware.

Business Law

M87

Items 7 through 9 are based on the following information:

White, Grey, and Fox formed a limited partnership. White is the general partner and Grey and Fox are the limited partners. Each agreed to contribute \$200,000. Grey and Fox each contributed \$200,000 in cash while White contributed \$150,000 in cash and \$50,000 worth of services already rendered. After two years, the partnership is insolvent. The fair market value of the assets of the partnership is \$150,000 and the liabilities total \$275,000. The partners have made no withdrawals.

7. If Fox is insolvent and White and Grey each has a net worth in excess of \$300,000, what is White's maximum potential liability in the event of a dissolution of the partnership?

- a. \$ 62,500
- b. \$112,500
- c. \$125,000
- d. \$175,000

8. Unless otherwise provided in the certificate of limited partnership, which of the following is correct if Fox assigns her interest in the partnership to Barr and only White consents to Barr's admission as a limited partner?

- a. Barr will **not** become a substituted limited partner unless Grey also consents.
- b. Barr will have the right to inspect the partnership's books.
- c. The partnership will be dissolved.
- d. Barr will become a substituted limited partner because White, as general partner, consented.

9. Unless otherwise provided in the certificate of limited partnership, which of the following is correct if Grey dies?

- a. Grey's executor will automatically become a substituted limited partner.
- b. Grey's executor will have all the rights of a limited partner for the purpose of settling the estate.
- c. The partnership will automatically be dissolved.
- d. Grey's estate will be free from any liabilities which may have been incurred by Grey as a limited partner.

M87#10. With respect to the following matters, which is correct if a general partnership agreement is silent?

- a. A partnership will continue indefinitely unless a majority of the partners votes to dissolve the partnership.
- b. Partnership losses are allocated in the same proportion as partnership profits.

- c. A partner may assign his interest in the partnership but only with the consent of the other partners.
- d. A partner may sell the goodwill of the partnership without the consent of the other partners when the sale is in the best interest of the partnership.

M86

Items 55 and 56 are based on the following information:

Ted Fein, a partner in the ABC Partnership, wishes to withdraw from the partnership and sell his interest to Gold. All of the other partners in ABC have agreed to admit Gold as a partner and to hold Fein harmless for the past, present, and future liabilities of ABC. A provision in the original partnership agreement states that the partnership will continue upon the death or withdrawal of one or more of the partners.

55. As a result of Fein's withdrawal and Gold's admission to the partnership, Gold

- a. Is personally liable for partnership liabilities arising before and after his admission as a partner.
- b. Has the right to participate in the management of ABC.
- c. Acquired only the right to receive Fein's share of the profits of ABC.
- d. Must contribute cash or property to ABC in order to be admitted with the same rights as the other partners.

56. The agreement to hold Fein harmless for all past, present, and future liabilities of ABC will

- a. Prevent partnership creditors from holding Fein personally liable only as to those liabilities of ABC existing at the time of Fein's withdrawal.
- b. Prevent partnership creditors from holding Fein personally liable for the past, present, and future liabilities of ABC.
- c. Not affect the rights of partnership creditors to hold Fein personally liable for those liabilities of ABC existing at the time of his withdrawal.
- d. Permit Fein to recover from the other partners only amounts he has paid in excess of his proportionate share.

M86#58. Noll Corp. and Orr Co. are contemplating entering into an unincorporated joint venture. Such a joint venture

- a. Will be treated as a partnership in most important legal respects.
- b. Must be dissolved upon completion of a single undertaking.
- c. Will be treated as an association for federal income tax purposes and taxed at the prevailing corporate rates.
- d. Must file a certificate of limited partnership with the appropriate state agency.

Selected Questions

M85#7. Which of the following statements is correct regarding a limited partnership?

- a. The general partner must make a capital contribution.
- b. It can only be created pursuant to a statute providing for the formation of limited partnerships.
- c. It can be created with limited liability for all partners.
- d. At least one general partner must also be a limited partner.

M85#8. Jane White acquired Zelmo's partnership interest in ZBA Partnership. All partners agreed to admit White as a partner. Unless otherwise agreed, White's admission to the partnership will automatically

- a. Release Zelmo from personal liability on partnership debts arising prior to the sale of his partnership interest.
- b. Release Zelmo from any liability on partnership debts arising subsequent to the sale of his partnership interest.
- c. Subject White to unlimited personal liability on partnership debts arising prior to her admission as a partner.
- d. Limit White's liability on partnership debts arising prior to her admission as a partner to her interest in partnership property.

M85#9. Unless otherwise provided for, the assignment of a partnership interest will result in the

- a. Dissolution of the partnership.
- b. Assignee obtaining the right to receive the share of the profits to which the assignor would have otherwise been entitled.
- c. Assignee succeeding to the assignor's rights to participate in the management of the partnership.
- d. Vesting of the assignor's right to inspect the partnership books in the assignee.

M85#10. Long, Pine, and Rice originally contributed \$100,000, \$60,000, and \$20,000, respectively, to form the LPR Partnership. Profits and losses of LPR are to be distributed $\frac{1}{2}$ to Long, $\frac{1}{3}$ to Pine, and $\frac{1}{6}$ to Rice. After operating for one year, LPR's total assets on its books are \$244,000, total liabilities to outside creditors are \$160,000 and total capital is \$84,000. The partners made no withdrawals. LPR has decided to liquidate. If all of the partners are solvent and the assets of LPR are sold for \$172,000

- a. Rice will personally have to contribute an additional \$8,000.
- b. Pine will personally have to contribute an additional \$4,000.
- c. Long, Pine, and Rice will receive \$6,000, \$4,000, and \$2,000, respectively, as a return of capital.
- d. Long and Pine will receive \$28,000 and \$4,000, respectively, and Rice will have to contribute an additional \$20,000.

C. Corporations

N88#5. Which of the following statements is correct with respect to the differences and similarities between a corporation and a limited partnership?

- a. Directors owe fiduciary duties to the corporation and limited partners owe such duties to the partnership.
- b. A corporation and a limited partnership may be created only pursuant to a state statute and a copy of its organizational document must be filed with the proper state agency.
- c. Shareholders may be entitled to vote on corporate matters whereas limited partners are prohibited from voting on any partnership matters.
- d. Stock of a corporation may be subject to the federal securities laws registration requirements whereas limited partnership interests are automatically exempt from such requirements.

N88#6. Krieg's will created a trust to take effect upon Krieg's death. The will named Krieg's spouse as both the trustee and personal representative (executor) of the estate. The will provided that all of Krieg's securities were to be transferred to the trust and named Krieg's child as the beneficiary of the trust. Under the circumstances,

- a. Krieg has created a testamentary trust.
- b. Krieg's spouse may **not** serve as both the trustee and personal representative because of the inherent conflict of interest.
- c. Krieg has created an inter vivos trust.
- d. The trust is invalid because it will **not** become effective until Krieg's death.

M88#15. In general, which of the following statements concerning treasury stock is correct?

- a. A corporation may **not** reacquire its own stock unless specifically authorized by its articles of incorporation.
- b. On issuance of new stock, a corporation has preemptive rights with regard to its treasury stock.
- c. Treasury stock may be distributed as a stock dividend.
- d. A corporation is entitled to receive cash dividends on its treasury stock.

M87#1. The corporate veil is most likely to be pierced and the shareholders held personally liable if

- a. An ultra vires act has been committed.
- b. The corporation has elected S corporation status under the Internal Revenue Code.
- c. A partnership incorporates its business solely to limit the liability of its partners.
- d. The shareholders have commingled their personal funds with those of the corporation.

M87#2. West owns 5,000 shares of \$7 cumulative preferred stock of Sky Corp. During the first year of operations, cash dividends of \$7 per share were declared on Sky's preferred stock but were never paid. In the second year of operations, dividends on Sky's preferred stock were neither declared nor paid. If Sky is dissolved, which of the following statements is correct?

- West will have priority over the claims of Sky's debenture bond owners.
- West will have priority over the claims of Sky's unsecured judgment creditors.
- Sky will be liable to West as an unsecured creditor for \$35,000.
- Sky will be liable to West as an unsecured creditor for \$70,000.

M87#3. In general, which of the following must be contained in articles of incorporation?

- The names of states in which the corporation will be doing business.
- The name of the state in which the corporation will maintain its principal place of business.
- The names of the initial officers and their terms of office.
- The classes of stock authorized for issuance.

N85#2. Orr Corp. declared a 7% stock dividend on its common stock. The dividend

- Is includable in the gross income of the recipient taxpayers in the year of receipt.
- Must be registered with the SEC pursuant to the Securities Act of 1933.
- Requires a vote of the shareholders of Orr.
- Has no effect on the earnings and profits for federal income tax purposes.

N85

Items 3 and 4 are based on the following information:

Jane Cox, a shareholder of Mix Corp., has properly commenced a derivative action against Mix's Board of Directors. Cox alleges that the Board breached its fiduciary duty and was negligent by failing to independently verify the financial statements prepared by management upon which Smart & Co., CPAs, issued an unqualified opinion. The financial statements contained inaccurate information which the Board relied upon in committing large sums of money to capital expansion. This resulted in Mix having to borrow money at extremely high interest rates to meet current cash needs. Within a short period of time, the price of Mix Corp. stock declined drastically.

3. Which of the following statements is correct?

- The Board is strictly liable, regardless of fault, since it owes a fiduciary duty to both the corporation and the shareholders.
- The Board is liable since any negligence of Smart is automatically imputed to the Board.

- The Board may avoid liability if it acted in good faith and in a reasonable manner.
- The Board may avoid liability in all cases where it can show that it lacked scienter.

4. If the court determines that the Board was negligent and the Board seeks indemnification for its legal fees from Mix, which of the following statements is correct?

- The Board may **not** be indemnified since a presumption that the Board failed to act in good faith arises from the judgment.
- The Board may **not** be indemnified unless Mix's shareholders approve such indemnification.
- The Board may be indemnified by Mix only if Mix provides liability insurance for its officers and directors.
- The Board may be indemnified by Mix only if the court deems it proper.

N85#5. Rice is a promoter of a corporation to be known as Dex Corp. On January 1, 1985, Rice signed a nine-month contract with Roe, a CPA, which provided that Roe would perform certain accounting services for Dex. Rice did not disclose to Roe that Dex had not been formed. Prior to the incorporation of Dex on February 1, 1985, Roe rendered accounting services pursuant to the contract. After rendering accounting services for an additional period of six months pursuant to the contract, Roe was discharged without cause by the board of directors of Dex. In the absence of any agreements to the contrary, who will be liable to Roe for breach of contract?

- Both Rice and Dex.
- Rice only.
- Dex only.
- Neither Rice nor Dex.

M85#11. Which of the following is a correct statement concerning the similarities of a limited partnership and a corporation?

- Both are recognized for federal income tax purposes as taxable entities.
- Both can only be created pursuant to a statute and each must file a copy of its certificate with the proper state authorities.
- Both provide insulation from personal liability for all of the owners of the business.
- Shareholders and limited partners may both participate in the management of the business and retain limited liability.

M85#12. Which of the following statements is correct regarding the fiduciary duty?

- A director's fiduciary duty to the corporation may be discharged by merely disclosing his self-interest.
- A director owes a fiduciary duty to the shareholders but **not** to the corporation.

Selected Questions

- c. A promoter of a corporation to be formed owes **no** fiduciary duty to anyone, unless the contract engaging the promoter so provides.
- d. A majority shareholder as such may owe a fiduciary duty to fellow shareholders.

M85#14. Generally, officers of a corporation

- a. Are elected by the shareholders.
- b. Are agents and fiduciaries of the corporation, having actual and apparent authority to manage the business.
- c. May be removed by the board of directors without cause only if the removal is approved by a majority vote of the shareholders.
- d. May declare dividends or other distributions to shareholders as they deem appropriate.

M85#15. The essential difference between a stock dividend and a stock split is that a

- a. Stock split will increase the amount of stockholders' equity.
- b. Stock split will increase a stockholder's percentage of ownership.
- c. Stock dividend must be paid in the same class of stock as held by the stockholder.
- d. Stock dividend of newly issued shares will result in a decrease in retained earnings.

D. Estates and Trusts

M89#17. Generally, an estate is liable for which debts owed by the decedent at the time of death?

- a. All of the decedent's debts.
- b. Only debts secured by the decedent's property.
- c. Only debts covered by the statute of frauds.
- d. None of the decedent's debts.

M89#18. A trust agreement is silent on the allocation of the following trust receipts between principal and income:

- | | |
|---|---------|
| • Cash dividends on investments in common stock | \$1,000 |
| • Royalties from property subject to depletion | \$2,000 |

What is the total amount of the trust receipts that should be allocated to trust income?

- a. \$0
- b. \$1,000
- c. \$2,000
- d. \$3,000

M89#19. A personal representative of an estate would breach fiduciary duties if the personal representative

- a. Combined personal funds with funds of the estate so that both could purchase treasury bills.

- b. Represented the estate in a lawsuit brought against it by a disgruntled relative of the decedent.
- c. Distributed property in satisfaction of the decedent's debts.
- d. Engaged a non-CPA to prepare the records for the estate's final accounting.

M89#20. A trust was created in 1980 to provide funds for sending the settlor's child through medical school. The trust agreement specified that the trust was to terminate in 1987. The child entered medical school in 1983, took a leave of absence in 1984, and died in 1986. This trust terminated in

- a. 1983
- b. 1984
- c. 1986
- d. 1987

N88#7. The limited liability of the shareholders of a closely-held corporation will most likely be disregarded if the shareholders

- a. Lend money to the corporation.
- b. Are also corporate officers, directors, or employees.
- c. Undercapitalized the corporation when it was formed.
- d. Formed the corporation solely to limit their personal liability.

N88

Items 8 and 9 are based on the following:

On January 1, 1988, Dix transferred certain assets into a trust. The assets consisted of Lux Corp. bonds with a face amount of \$500,000 and an interest rate of 12%. The trust instrument named Dix as trustee, Dix's child as life beneficiary, and Dix's grandchild as remainderman. Interest on the bonds is payable semi-annually on May 1 and November 1. Dix had purchased the bonds at their face amount. As of January 1, 1988, the bonds had a fair market value of \$600,000. The accounting period selected for the trust is a calendar year. The trust instrument is silent as to whether Dix may revoke the trust.

- 8. Which of the following statements is correct?
 - a. Dix is **not** a fiduciary because Dix is also the creator (settlor).
 - b. The trust is invalid under the merger doctrine because Dix is both the creator and the trustee.
 - c. A duty is owed by Dix to administer the trust property for the sole benefit of the beneficiaries.
 - d. Dix has the implied right to revoke the trust without the court's permission.

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9. Assuming the trust is valid, how should the amount of interest received in 1988 be allocated between principal and income if the trust instrument is otherwise silent?

	<u>Principal</u>	<u>Income</u>
a.	\$0	\$60,000
b.	\$0	\$72,000
c.	\$10,000	\$50,000
d.	\$12,000	\$60,000

M88#10. To create a valid inter vivos trust to hold personal property, the trust must be

- In writing and signed by the settlor (creator).
- Specific concerning the property to be held in trust.
- Irrevocable.
- In writing and signed by the trustee.

M88

Items 11 and 12 are based on the following information:

Rusk properly created an inter vivos trust naming Gold as the trustee. The sole asset of the trust is an office building that is fully rented. Rental receipts exceed expenditures. The trust instrument is silent as to the allocation of items between principal and income.

11. Among the items to be allocated by Gold during the year are insurance proceeds received as a result of fire damage to the building and the mortgage interest payments made during the year. Which of the following items is properly allocable to principal?

	<u>Insurance proceeds on building</u>	<u>Current mortgage interest payments</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

12. Which of the following statements is correct concerning Gold's responsibility as trustee?

- Gold's duty of loyalty will be breached by Gold's purchasing assets from the trust despite a provision in the trust agreement permitting such a purchase.
- Gold owes a duty of loyalty to the trust but not to the beneficiaries.
- Gold must exercise reasonable care and skill while performing the duties of a trustee.
- Gold will be free from personal liability with regard to all contracts entered into by Gold on behalf of the trust absent fraud by Gold.

N87#16. On June 16, 1987, Eble placed 800 shares of Singh Corp.'s common stock in a trust for the benefit of Eble's child. On June 1, 1987, Singh's board of directors had declared a cash dividend of \$2 per share on

Singh's common stock. Payment was made on July 30, 1987, to shareholders of record on June 30, 1987. What amount of the dividend should be allocated to trust income?

- \$0
- \$ 800
- \$1,200
- \$1,600

N87

Items 17 and 18 are based on the following information:

Rita Ryan died leaving a will naming her children, John and Dale, as the sole beneficiaries. In her will, Rita designated John as the executor of her estate and excused John from posting a bond as executor. At the time of Rita's death, she owned a parcel of land with her sister, Ann, as joint tenants with right of survivorship.

17. With respect to Rita's interest in the land, it will pass to

- John and Dale outside Rita's estate by operation of law.
- John and Dale through Rita's estate after the will is probated.
- Ann through Rita's estate after the will is probated.
- Ann outside Rita's estate by operation of law.

18. In general, John as executor, must

- Post a bond despite the provision to the contrary in Rita's will.
- Serve without compensation because John is also a named beneficiary in the will.
- File a final account of the administration of the estate.
- Relinquish the duties because of the conflict of interest as executor and beneficiary.

M86#51. Ed Roth, a retired businessman, plans to travel extensively during the upcoming year. Roth is concerned that he may not be able to handle the daily activities associated with his financial affairs. As a solution, Roth created a trust and transferred most of his investment assets to Long Bank, as trustee, naming himself as the trust's sole beneficiary. Which of the following statements is correct?

- The trust is invalid under the merger doctrine since the creator and the beneficiary are the same person.
- Long has a fiduciary duty to the trust but not to Roth as beneficiary.
- Roth has created a testamentary trust.
- Roth has created an inter vivos trust.

M86#52. Ryan is the trustee of the Carr Family Trust. The assets of the trust are various income-producing real estate properties. The trust instrument is silent as to the allocation of items between principal and income.

Selected Questions

Among the items to be allocated by Ryan during the first year were depreciation and the cost of a new roof. Which are properly allocable to income?

	<u>Depreciation</u>	<u>Cost of a new roof</u>
a.	No	No
b.	Yes	No
c.	Yes	Yes
d.	No	Yes

M86#53. Which of the following statements is correct with respect to a trustee?

- The trustee is liable for losses which result from a delegation of any duty by him.
- The trustee can **not** purchase property from the trust even if the trust instrument authorizes it.
- In the absence of a provision otherwise in the trust instrument, the trustee has the responsibility to invest the trust property so as to produce income.
- The trustee will be free from personal liability with regard to all contracts entered into by him on behalf of the trust and on debts incurred by the trust.

M86#54. Okun, a major shareholder in Stale Corp., placed all of his shares of stock in a trust for the benefit of his three children. The purpose of the trust was to provide an entity through which the dividends paid on the stock would pass to his children for their lives. The

trust instrument was silent as to whether Okun may terminate the trust. If Okun wishes to terminate the trust, he may

- Not do so since the trust instrument is silent on this point.
- Not do so since a trust may only be terminated with court permission.
- Do so since such a right is impliedly reserved by Okun.
- Do so only if the trustee also agrees to terminate the trust.

N85#58. A distinguishing feature between the making of an inter vivos gift and the creation of a trust is that

- A gift may be made orally whereas a trust must be in a signed writing.
- Generally, a gift is irrevocable whereas a trust may be revoked in certain cases.
- In order to create a valid trust, the creator must receive some form of consideration.
- The beneficiary of a trust must be notified of the trust's creation.

M85#58. Fine wishes to establish an inter vivos trust for the benefit of his daughter Sally, naming Sally as the sole income beneficiary for 20 years and as the sole remainder beneficiary of the corpus. The intended trust will fail if the instrument creating the trust

- Provides for the trustee to serve without compensation, bond or other security.
- Is **not** supported by any consideration.
- Fails to name a trustee.
- Names Sally as the sole trustee.

III. Contracts

A. Offer and Acceptance

M89#21. Martin wrote Dall and offered to sell Dall a building for \$200,000. The offer stated it would expire 30 days from April 1. Martin changed his mind and does not wish to be bound by his offer. If a legal dispute arises between the parties regarding whether there has been a valid acceptance of the offer, which one of the following is correct?

- The offer cannot be legally withdrawn for the stated period of time.
- The offer will **not** expire before the 30 days even if Martin sells the property to a third person and notifies Dall.
- If Dall categorically rejects the offer on April 10, Dall cannot validly accept within the remaining stated period of time.
- If Dall phoned Martin on May 3, and unequivocally accepted the offer, a contract would be created, provided that Dall had **no** notice of withdrawal of the offer.

M89#22. Which of the following statements concerning the effectiveness of an offeree's rejection and an offeror's revocation of an offer is generally correct?

	<u>An offeree's rejection is effective when</u>	<u>An offeror's revocation is effective when</u>
a.	Received by offeror	Sent by offeror
b.	Sent by offeree	Received by offeree
c.	Sent by offeror	Sent by offeror
d.	Received by offeror	Received by offeree

M89#23. An offer is **not** terminated by operation of law solely because the

- Offeror dies.
- Offeree is adjudicated insane.
- Subject matter is destroyed.
- Subject matter is sold to a third party.

M89#25. To announce the grand opening of a new retail business, Hudson placed an advertisement in a local newspaper quoting sales prices on certain items in stock. The grand opening was so successful that Hudson was unable to totally satisfy customer demands. Which of the following statements is correct?

- a. Hudson made an invitation seeking offers.
- b. Hudson made an offer to the people who read the advertisement.
- c. Anyone who tendered money for the items advertised was entitled to buy them.
- d. The offer by Hudson was partially revocable as to an item once it was sold out.

N88#10. The president of Deal Corp. wrote to Boyd, offering to sell the Deal factory for \$300,000. The offer was sent by Deal on June 5 and was received by Boyd on June 9. The offer stated that it would remain open until December 20. The offer

- a. Constitutes an enforceable option.
- b. May be revoked by Deal any time prior to Boyd's acceptance.
- c. Is a firm offer under the UCC but will be irrevocable for only three months.
- d. Is a firm offer under the UCC because it is in writing.

N88

Items 11 and 12 are based on the following:

On April 2, Jet Co. wrote to Ard, offering to buy Ard's building for \$350,000. The offer contained all of the essential terms to form a binding contract and was duly signed by Jet's president. It further provided that the offer would remain open until May 30 and an acceptance would not be effective until received by Jet. On April 10, Ard accepted Jet's offer by mail. The acceptance was received by Jet on April 14.

11. *For this item only*, assume that on April 11 Jet sent a telegram to Ard revoking its offer and that Ard received the telegram on April 12. Under the circumstances,

- a. A contract was formed on April 10.
- b. A contract was formed on April 14.
- c. Jet's revocation effectively terminated its offer on April 12.
- d. Jet's revocation effectively terminated its offer on April 11.

12. *For this item only*, assume that on April 13 Ard sent a telegram to Jet withdrawing the acceptance and rejecting Jet's offer and that Jet received the telegram on April 15. Under the circumstances,

- a. A contract was formed on April 14.
- b. A contract was formed on April 10.
- c. Ard's rejection effectively terminated Jet's offer on April 13.
- d. Ard's rejection effectively terminated Jet's offer on April 15.

M88#16. In order for an offer to confer the power to form a contract by acceptance, it must have all of the following elements **except**

- a. Be communicated to the offeree and the communication must be made or authorized by the offeror.
- b. Be sufficiently definite and certain.
- c. Be communicated by words to the offeree by the offeror.
- d. Manifest an intent to enter into a contract.

M88#17. On July 1, Silk, Inc., sent Blue a telegram offering to sell Blue a building for \$80,000. In the telegram, Silk stated that it would give Blue 30 days to accept the offer. On July 15, Blue sent Silk a telegram that included the following statement: "The price for your building seems too high. Would you consider taking \$75,000?" This telegram was received by Silk on July 16. On July 19, Tint made an offer to Silk to purchase the building for \$82,000. Upon learning of Tint's offer, Blue, on July 27, sent Silk a signed letter agreeing to purchase the building for \$80,000. This letter was received by Silk on July 29. However, Silk now refuses to sell Blue the building. If Blue commences an action against Silk for breach of contract, Blue will

- a. Win, because Blue effectively accepted Silk's offer of July 1.
- b. Win, because Silk was obligated to keep the offer open for the 30-day period.
- c. Lose, because Blue sent the July 15 telegram.
- d. Lose, because Blue used an unauthorized means of communication.

M87#11. On April 2, 1987, Bonn & Co., CPAs, mailed Marble Corp. a signed proposal to perform certain accounting services for Marble provided Marble accepts the proposal by April 30, 1987. Under the circumstances,

- a. If Marble accepts by telephone on April 30, 1987, **no** contract will be formed between the parties.
- b. Marble must accept the Bonn proposal in writing in order to form a contract.
- c. A contract will be formed between the parties if Marble mails an acceptance to Bonn on April 29, 1987, even if it is **not** received by Bonn until May 3, 1987.
- d. Bonn may **not** withdraw its proposal prior to May 1, 1987.

M87#12. Beal offered in writing to sell Crane a parcel of land for \$150,000. If Beal dies, the offer will

- a. Automatically terminate prior to Crane's acceptance.
- b. Automatically terminate despite Crane's prior acceptance.
- c. Terminate prior to Crane's acceptance only if Crane received notice of Beal's death.
- d. Remain open for a reasonable period of time after Beal's death.

Selected Questions

M87

Items 15 and 16 are based on the following information:

On March 1, Mirk Corp. wrote to Carr offering to sell Carr its office building for \$280,000. The offer stated that it would remain open until July 1. It further stated that acceptance must be by telegram and would be effective only upon receipt.

15. For this question only, assume that Carr telegraphed its acceptance on June 28 and that it was received by Mirk on July 2. Which of the following statements is correct?

- a. A contract was formed when Carr telegraphed its acceptance.
- b. A contract was formed when Mirk received Carr's acceptance.
- c. No contract was formed because three months had elapsed since the offer was made.
- d. No contract was formed since the acceptance was received after July 1.

16. For this question only, assume that on May 10, Mirk mailed a letter to Carr revoking its offer of March 1. Carr did not learn of Mirk's revocation until Carr received the letter on May 17. Carr had already sent a telegram of acceptance to Mirk on May 14, which was received by Mirk on May 16. Which of the following statements is correct?

- a. Carr's telegram of acceptance was effective on May 16.
- b. Mirk's offer of March 1 was irrevocable and therefore could not be withdrawn prior to July 1.
- c. Mirk's letter of revocation effectively terminated its offer of March 1 when mailed.
- d. Carr's telegram of acceptance was effective on May 14.

N86#12. Stable Corp. offered in a signed writing to sell Mix an office building for \$350,000. The offer, which was sent by Stable on April 1, indicated that it would remain open until July 9. On July 5, Mix mailed a letter rejecting Stable's offer. On July 6, Mix sent a telegram to Stable accepting the original offer. The letter of rejection was received by Stable on July 8 and the telegram of acceptance was received by Stable on July 7. Which of the following is correct?

- a. Mix's telegram resulted in the formation of a valid contract.
- b. Mix's letter of July 5 terminated Stable's offer when mailed.
- c. Stable was not entitled to withdraw its offer until after July 9.
- d. Although Stable's offer on April 1 was a firm offer under the UCC it will only remain open for three months.

N86#15. Kraft Corp. published circulars containing price quotes and a description of products which it would like to sell. Rice, a prospective customer, demands the right to purchase one of the products at the

quoted price. Which of the following statements is correct under general contract law?

- a. Kraft must sell the product which Rice demands at the quoted price.
- b. Rice has accepted Kraft's firm offer to sell.
- c. Kraft has made an offer.
- d. Rice has made an offer.

M86#1. Ted Marx sent Stahl & Co. a signed letter on January 3, 1986, offering to sell his warehouse for \$95,000. The letter indicated that the offer would remain open until January 30, 1986. On January 26, Stahl wrote Marx that it would be willing to pay \$88,000 for the warehouse. The letter was received by Marx on January 29. On January 28, Stahl was advised that a similar property had been sold for \$99,000. Based on this information, Stahl telephoned Marx on January 28 and accepted the original offer of January 3. Marx refused to sell the warehouse to Stahl for \$95,000. Which of the following statements is correct?

- a. Stahl's acceptance on January 28 formed a contract which bound Marx to the terms of his original offer.
- b. Marx's letter dated January 3 is a firm offer under the UCC.
- c. Stahl is barred under the parol evidence rule from introducing evidence of its oral acceptance since it contradicts its letter dated January 26.
- d. A contract was never formed since Stahl's letter of January 26 was a counteroffer which terminated Marx's offer when mailed.

M86#2. Able Sofa, Inc., sent Noll a letter offering to sell Noll a custom made sofa for \$5,000. Noll immediately sent a telegram to Able purporting to accept the offer. However, the telegraph company erroneously delivered the telegram to Abel Soda, Inc. Three days later, Able mailed a letter of revocation to Noll which was received by Noll. Able refused to sell Noll the sofa. Noll sued Able for breach of contract. Able

- a. Would have been liable under the deposited acceptance rule only if Noll had accepted by mail.
- b. Will avoid liability since it revoked its offer prior to receiving Noll's acceptance.
- c. Will be liable for breach of contract.
- d. Will avoid liability due to the telegraph company's error.

N85#7. Fenster Corp. requested Wein & Co., CPAs, to perform accounting services for it. Wein agreed to perform the services. Fenster and Wein had not discussed the amount of the fees. Which of the following is correct?

- a. No contract was formed since the amount of the fees was not agreed upon.
- b. A quasi contract was formed at the time Wein agreed to perform the services.
- c. A unilateral contract was formed at the time of Fenster's request.
- d. A bilateral contract was formed at the time of Wein's agreement to perform.

M85#11. On April 1, Knox signed and mailed a letter containing an offer to sell Wax a warehouse for \$75,000. The letter also indicated that the offer would expire on May 3. Which of the following is correct?

- The offer is a firm offer under the UCC and can **not** be withdrawn by Knox prior to May 3.
- Wax can benefit from the early acceptance rule **no** matter what means of communication he uses as long as the acceptance is sent on or before May 3.
- If Wax purports to accept the offer on April 15 at \$50,000 and Knox refuses to sell at that price, Wax nevertheless has the right to accept at \$75,000 by May 3.
- A telephone call by Wax to Knox on May 3, accepting the offer at \$75,000, will effectively bind Knox.

M85

Item 21 is based on the following information:

After substantial oral negotiations, Ida Frost wrote Jim Lane on May 1 offering to pay Lane \$160,000 to build a warehouse. The writing contained the terms essential to form a binding contract. It also provided that the offer would remain open until June 1 and that acceptance must be received to be effective. On May 20, Lane mailed a signed acceptance. This was received by Frost on May 22. Lane completed the warehouse on July 15. On July 30, Lane assigned his right to receive payment to Reid Bank which did not notify Frost of the assignment. Two weeks later, Frost paid Lane \$155,000 after deducting \$5,000 in satisfaction of a dispute between them unrelated to the construction contract.

21. Frost's offer
- Was accepted and a contract duly formed on May 20.
 - Was irrevocable until June 1.
 - Constituted a firm offer under the UCC despite the lack of consideration.
 - Could have been revoked any time prior to the receipt of Lane's acceptance on May 22.

B. Consideration

M89#24. Dye sent Hill a written offer to sell a tract of land located in Newtown for \$60,000. The parties were engaged in a separate dispute. The offer stated that it would be irrevocable for 60 days if Hill would promise to refrain from suing Dye during this time. Hill promptly delivered a promise not to sue during the term of the offer and to forego suit if Hill accepted the offer. Dye subsequently decided that the possible suit by Hill was groundless and therefore phoned Hill and revoked the offer 15 days after making it. Hill mailed an ac-

ceptance on the 20th day. Dye did not reply. Under the circumstances,

- Dye's offer was supported by consideration and was **not** revocable when accepted.
- Dye's written offer would be irrevocable even without consideration.
- Dye's silence was an acceptance of Hill's promise.
- Dye's revocation, **not** being in writing, was invalid.

M88#18. In deciding whether consideration necessary to form a contract exists, a court must determine whether

- The consideration given by each party is of roughly equal value.
- There is mutuality of consideration.
- The consideration has sufficient monetary value.
- The consideration conforms to the subjective intent of the parties.

N87#2. Blue purchased a travel agency business from Drye. The purchase price included payment for Drye's goodwill. The agreement contained a covenant prohibiting Drye from competing with Blue in the travel agency business. Which of the following statements regarding the covenant is **not** correct?

- The restraint must be **no** more extensive than is reasonably necessary to protect the goodwill purchased by Blue.
- The geographic area to which it applies must be reasonable.
- The time period for which it is to be effective must be reasonable.
- The value to be assigned to it is the excess of the price paid over the seller's cost of all tangible assets.

M87#14. Which of the following will be legally binding on all the parties despite the lack of consideration?

- A promise to donate money to a charity which was relied upon by the charity in incurring large expenditures.
- An oral employment agreement for a term of nine months from the date the agreement was formed.
- An irrevocable oral promise by a merchant to keep its offer open for 60 days.
- A material modification signed by the parties to a contract to purchase and sell a parcel of land.

M87#17. In order to satisfy the consideration requirement to form a contract, the consideration exchanged by the parties must

- Have a monetary value.
- Conform to the parties' subjective intent.
- Be legally sufficient.
- Have approximately the same value.

Selected Questions

N86#11. Which of the following requires consideration in order to be binding on the parties?

- a. A written promise signed by a merchant to keep an offer to sell goods open for 10 days.
- b. Material modification of a sale of goods contract under the UCC.
- c. Ratification of a contract by a person after reaching the age of majority.
- d. Material modification of a contract involving the sale of real estate.

M86#3. Polk is seeking to avoid performing a promise to pay Lake \$800. Polk is relying upon lack of consideration on Lake's part sufficient to support his promise. Polk will prevail if he can establish that

- a. Lake's only claim of consideration was the relinquishment of a legal right.
- b. Prior to Polk's promise, Lake had already performed the requested act.
- c. The contract is executory.
- d. Lake's asserted consideration is worth only \$250.

N85#13. In determining whether the consideration requirement has been satisfied to form a contract, the courts will be required to decide whether the consideration

- a. Was bargained for.
- b. Was fair and adequate.
- c. Has sufficient economic value.
- d. Conforms to the subjective intent of the parties.

C. Capacity, Legality, and Public Policy

M89#26. Tell, an Ohio real estate broker, misrepresented to Allen that Tell was licensed in Michigan under Michigan's statute regulating real estate brokers. Allen signed a standard form listing contract agreeing to pay Tell a 6% commission for selling Allen's home in Michigan. Tell sold Allen's home. Under the circumstances, Allen is

- a. Not liable to Tell for any amount because Allen signed a standard form contract.
- b. Not liable to Tell for any amount because Tell violated the Michigan licensing requirements.
- c. Liable to Tell only for the value of services rendered under a quasi-contract theory.
- d. Liable to Tell for the full commission under a promissory estoppel theory.

N88#13. Parr is the vice-president of research of Lynx, Inc. When hired, Parr signed an employment contract prohibiting Parr from competing with Lynx during and after employment. While employed, Parr acquired knowledge of many of Lynx's trade secrets. If Parr wishes to compete with Lynx and Lynx refuses to give Parr permission, which of the following statements is correct?

- a. Parr has the right to compete with Lynx upon resigning from Lynx.

- b. Parr has the right to compete with Lynx only if fired from Lynx.
- c. In determining whether Parr may compete with Lynx, the court should **not** consider Parr's ability to obtain other employment.
- d. In determining whether Parr may compete with Lynx, the court should consider, among other factors, whether the agreement is necessary to protect Lynx's legitimate business interests.

M88#19. Parr is a CPA licensed to practice in State A. Parr entered into a contract with Jet, Inc., to perform an audit in State B for \$50,000 (including expenses). After Parr had satisfactorily performed the audit, Jet discovered that Parr had violated State B's licensing statute by failing to obtain a CPA license in State B. Parr incurred \$10,000 in expenses in connection with the audit. Jet refuses to pay any fee to Parr, arguing that it could have engaged a local CPA licensed in State B to perform the same services for \$35,000 (including expenses). If Parr sues Jet based on breach of contract, Parr will be entitled to recover a maximum of

- a. \$0
- b. \$10,000
- c. \$35,000
- d. \$50,000

N87#3. With regard to an agreement for the sale of real estate, the statute of frauds

- a. Requires that the entire agreement be in a single writing.
- b. Requires that the purchase price be fair and adequate in relation to the value of the real estate.
- c. Does **not** require that the agreement be signed by all parties.
- d. Does **not** apply if the value of the real estate is less than \$500.

M87#18. Wert, an employee of Salam Corp., signed an agreement not to compete with Salam during and after being employed with Salam. Wert is the director of research and has knowledge of many of Salam's trade secrets. If Wert's employment with Salam is terminated and Wert wishes to compete with Salam, which of the following statements is **not** correct?

- a. The agreement is only enforceable if Wert voluntarily terminates his employment with Salam.
- b. The agreement must be necessary to protect Salam's legitimate interests in order to be enforceable.
- c. The geographic area covered by the agreement must be reasonable in order to be enforceable.
- d. The court will consider Wert's ability to obtain other employment against Salam's right to protect its business.

Business Law

N86#13. Meed entered into a written agreement to sell a parcel of land to Beel for \$80,000. At the time the agreement was executed, Meed had consumed a large amount of alcoholic beverages which significantly impaired Meed's ability to understand the nature and terms of the contract. Beel knew Meed was very intoxicated and that the land had been appraised at \$125,000. Meed wishes to avoid the contract. The contract is

- a. Void.
- b. Legally binding on both parties in the absence of fraud or undue influence.
- c. Voidable at Meed's option.
- d. Voidable at Meed's option only if the intoxication was involuntary.

N86#14. Samm, a plumber, entered into a contract for \$75,000 with Orr, Inc., to perform certain plumbing services in a building owned by Orr. After Samm had satisfactorily performed the work, Orr discovered that Samm had violated the state licensing statute by failing to obtain a plumbing license. The licensing statute was enacted merely to raise revenue for the state. An independent appraisal of Samm's work indicated that the building's fair market value increased by \$70,000 as a result of Samm's work. The cost of the materials which Samm supplied was \$35,000. If Samm sues Orr, Samm will be entitled to recover

- a. \$0
- b. \$35,000
- c. \$70,000
- d. \$75,000

M86#4. On May 1, 1985, Mint, a 16-year old, purchased a sail boat from Sly Boats. Mint used the boat for six months at which time he advertised it for sale. Which of the following statements is correct?

- a. The sale of the boat to Mint was void, thereby requiring Mint to return the boat and Sly to return the money received.
- b. The sale of the boat to Mint may be avoided by Sly at its option.
- c. Mint's use of the boat for six months after the sale on May 1 constituted a ratification of that contract.
- d. Mint may disaffirm the May 1 contract at any time prior to reaching majority.

M86#5. Todd is a licensed real estate broker in Ohio. One of Todd's largest clients, Sun Corp., contracted in writing with Todd to find a purchaser for its plant in New York and agreed to pay him a 6% commission if he were successful. Todd located a buyer who purchased the plant. Unknown to Todd, New York has a real estate broker's licensing statute which is regulatory in nature, intended to protect the public against unqualified persons. Todd violated the licensing statute by failing to obtain a New York license. If Sun refuses

to pay Todd any commission and Todd brings an action against Sun, he will be entitled to recover

- a. Nothing.
- b. A fee based on the actual hours spent.
- c. The commission agreed upon.
- d. Out of pocket expenses only.

D. Statute of Frauds

M89#27. Able hired Carr to restore Able's antique car for \$800. The terms of their oral agreement provided that Carr was to complete the work within 18 months. Actually, the work could be completed within one year. The agreement is

- a. Unenforceable because it covers services with a value in excess of \$500.
- b. Unenforceable because it covers a time period in excess of one year.
- c. Enforceable because personal service contracts are exempt from the Statute of Frauds.
- d. Enforceable because the work could be completed within one year.

M89#29. To satisfy the UCC Statute of Frauds, a written agreement for the sale of goods must

- a. Contain payment terms.
- b. Be signed by both buyer and seller.
- c. Indicate that a contract for sale has been made.
- d. Refer to the time and place of delivery.

N88#14. Payne borrowed \$500 from Onest Bank. At the time the loan was made to Payne, Gem orally agreed with Onest that Gem would repay the loan if Payne failed to do so. Gem received no personal benefit as a result of the loan to Payne. Under the circumstances,

- a. Gem is secondarily liable to repay the loan.
- b. Both Gem and Payne are primarily liable to repay the loan.
- c. Gem is free from liability concerning the loan.
- d. Gem is primarily liable to repay the loan.

M88#20. On May 1, Dix and Wilk entered into an oral agreement by which Dix agreed to purchase a small parcel of land from Wilk for \$450. Dix paid Wilk \$100 as a deposit. The following day, Wilk received another offer to purchase the land for \$650, the fair market value. Wilk immediately notified Dix that Wilk would not sell the land for \$450. If Dix sues Wilk for specific performance, Dix will

- a. Prevail, because the amount of the contract was less than \$500.
- b. Prevail, because there was part performance.
- c. Lose, because the fair market value of the land is over \$500.
- d. Lose, because the agreement was **not** in writing and signed by Wilk.

Selected Questions

M87#13. On April 2, 1986, Streb entered into an oral employment contract with Xeon, Inc. for a term of three years at a salary of \$2,000 per week. On June 10, 1986, Streb was terminated by Xeon. On July 10, 1986, Streb commenced an action for breach of the employment contract. Xeon has asserted the statute of frauds as a defense. On July 30, 1986, Streb died. Under the circumstances, the employment contract is

- a. Unenforceable since the value of the consideration given exceeds \$500.
- b. Unenforceable since it was **not** in writing and signed by Xeon.
- c. Enforceable since it was possible that the contract could have been performed within one year from the making of the contract.
- d. Enforceable since Streb's death occurred within one year from the making of the contract.

N86#16. Stahl Corp. entered into a written contract to purchase a warehouse from Mehl for \$85,000. Thereafter, Mehl received an offer from another purchaser to buy the warehouse for \$95,000. As a result, Mehl has refused to transfer the warehouse to Stahl. Stahl has commenced an action for specific performance. Mehl has raised the statute of frauds as a defense. In order for Stahl to successfully prevail on the statute of frauds issue, it must be shown among other requirements that the contract was signed by

- a. Mehl.
- b. Stahl.
- c. Mehl and Stahl at the same time.
- d. Mehl and Stahl with proper notarizations affixed to the contract.

M86#6. On April 3, 1985, Fier entered into an oral employment contract with Reich, whereby Reich was hired as a sales manager for a term of one year. Although Fier and Reich did not agree to a definite starting date, Fier indicated that Reich could begin employment that same day or any time prior to April 15, 1985. Reich began working on April 10. On June 15, 1985, Reich was fired without cause. If Reich sues for breach of the employment contract and Fier asserts the statute of frauds as a defense, Reich will

- a. Prevail since the contract was capable of being performed within one year.
- b. Prevail since the UCC statute of frauds applies.
- c. Lose since the contract was **not** in writing and signed by Fier.
- d. Lose since Reich did **not** begin employment until April 10.

N85#9. The statute of frauds

- a. Requires the formalization of a contract in a single writing.
- b. Applies to all contracts having a consideration valued at \$500 or more.

- c. Applies to the sale of real estate but **not** to any leases.
- d. Does **not** require that the contract be signed by all parties.

E. Statute of Limitations

M88#22. On May 1, 1972, Mix, CPA, entered into an oral contract with Dell to provide certain accounting services to Dell. The contract was fully performed by both parties in 1974. On April 25, 1988, Dell commenced a breach of contract action against Mix claiming that Mix had improperly performed the accounting services. Mix's best defense to the action would likely be the

- a. Parol evidence rule.
- b. Statute of limitations.
- c. Statute of frauds.
- d. Lack of consideration.

N86#17. Sklar, CPA, purchased from Wiz Corp. two computers. Sklar discovered material defects in the computers 10 months after taking delivery. Three years after discovering the defects, Sklar commenced an action for breach of warranty against Wiz. Wiz has raised the statute of limitations as a defense. The original contract between Wiz and Sklar contained a conspicuous clause providing that the statute of limitations for breach of warranty actions would be limited to 18 months. Under the circumstances, Sklar will

- a. Win because the action was commenced within the four-year period as measured from the date of delivery.
- b. Win because the action was commenced within the four-year period as measured from the time he discovered the breach or should have discovered the breach.
- c. Lose because the clause providing that the statute of limitations would be limited to 18 months is enforceable.
- d. Lose because the statute of limitations is three years from the date of delivery with respect to written contracts.

M86#7. Simon has been sued by Major for breach of a real estate contract. Simon has raised the statute of limitations as a defense to Major's lawsuit. Under the circumstances, the statute of limitations

- a. Runs continuously under all circumstances commencing at the time the contract is breached.
- b. Does **not** apply to the contract between Simon and Major because it involves real estate.
- c. Will prevent recovery where the time set forth in the statute has expired.
- d. Is four years in all states.

M85#24. Diel entered into a written contract to sell a building to Stone. The contract was properly recorded. Stone breached the contract and Diel has brought an action for breach of contract. Stone pleads the statute of limitations as a defense. The

- a. Time period fixed by the statute of limitations is uniform throughout the states.
- b. Recording of the contract stops the running of the statute of limitations.
- c. Time period fixed by the statute of limitations begins when the contract is recorded.
- d. Remedy sought by Diel will be barred when the period of time provided by the statute of limitations has expired.

F. Fraud, Duress, and Undue Influence

M89#28. King had several outstanding unsecured loans with National Bank. In addition, King had a separate loan with National that was secured by a mortgage on a farm owned by King. King was delinquent on the mortgage loan but not on the unsecured loans. National asked King to sign renewal notes for the unsecured loans at substantially higher interest rates. When King refused, National informed King that it would foreclose on the farm's mortgage if King did not sign. King signed but later disaffirmed the new unsecured notes and National sued. King's best defense is

- a. Undue influence.
- b. Unconscionability.
- c. Duress.
- d. Fraud in the inducement.

N88#15. The intent or scienter element necessary to establish a cause of action for fraud will be satisfied if the plaintiff can establish that the

- a. Plaintiff actually relied on the defendant's misrepresentation.
- b. Plaintiff justifiably relied on the defendant's misrepresentation.
- c. Defendant made a false representation of fact.
- d. Defendant made a misrepresentation with a reckless disregard for the truth.

M88#25. To establish a cause of action based on fraud in the inducement, one of the elements the plaintiff must generally prove is that

- a. It is impossible for the plaintiff to perform the terms of the contract.
- b. The contract is unconscionable.
- c. The defendant made a false representation of a material fact.
- d. There has been a mutual mistake of a material fact by the plaintiff and defendant.

N87#4. Sisk contracted to sell Bleu a building for \$470,000. If Sisk wishes to avoid the contract based on undue influence, one element that Sisk must prove is that Bleu

- a. Induced Sisk to sell the building by unfair persuasion.

- b. Was in a fiduciary relationship with Sisk.
- c. Misrepresented material facts to Sisk.
- d. Made improper threats to Sisk.

M87#19. Baker fraudulently induced Able to sell Baker a painting for \$200. Subsequently, Baker sold the painting for \$10,000 to Gold, a good faith purchaser. Able is entitled to

- a. Rescind the contract with Baker.
- b. Recover the painting from Gold.
- c. Recover damages from Baker.
- d. Rescind Baker's contract with Gold.

M87#20. In order for a purchaser of land to avoid a contract with the seller based on duress, it must be shown that the seller's improper threats

- a. Constituted a crime or tort.
- b. Actually induced the purchaser to assent to the contract.
- c. Would have induced a reasonably prudent person to assent to the contract.
- d. Were made with the intent that the purchaser be influenced by them.

N86

Items 19 through 20 are based on the following information:

Bob Meyer sold a parcel of land to Sam Stein for \$85,000. Meyer agreed to accept as payment Stein's promissory note in the amount of \$60,000 and cash of \$25,000. During the course of negotiations Stein misrepresented his financial condition. Furthermore, at the closing Stein made improper threats to Meyer when Meyer indicated he did not want to go through with the deal. As a result of the threats, Meyer did execute and deliver a deed to the land. Meyer wishes to rescind the contract and has commenced an action based upon common law fraud, duress, and innocent misrepresentation. Meyer's complaint contains the following allegations:

- I. Stein materially misrepresented his financial condition.
- II. Stein had actual or constructive knowledge that the representations made during the negotiations were false.
- III. Meyer entered into the contract because of Stein's improper threats.
- IV. Meyer justifiably relied upon Stein's false representations made during the negotiations.
- V. Meyer suffered physical harm as a result of the improper threats.

19. Which statements contained in Meyer's complaint are necessary to establish the action for common law fraud?

- a. I and II only.
- b. I and IV only.
- c. II and IV only.
- d. I, II, and IV.

Selected Questions

20. Which statement(s) contained in Meyer's complaint would be necessary to establish the action for duress?

- a. III only.
- b. III and IV.
- c. III and V.
- d. V only.

M86#8. Sardy, a famous football player, was asked to autograph a pad of paper held by Maple. Unknown to Sardy, Maple had carefully concealed a contract for the sale of Sardy's home to Maple in the pad which Sardy signed. If Maple seeks to enforce the contract, Sardy's best defense to have the contract declared void would be

- a. Fraud in the inducement.
- b. Fraud in the execution.
- c. Mistake.
- d. Duress.

M86#10. Carter owns a parcel of land. Smith, one of Carter's closest friends and an attorney, has persuaded Carter to sell the land to Smith at a price substantially below fair market value. At the time Carter sold the land he was resting in a nursing home recovering from a serious illness. If Carter desires to set aside the sale, which of the following causes of action is most likely to be successful?

- a. Duress.
- b. Undue influence.
- c. Fraud.
- d. Misrepresentation.

N85#10. One of the elements necessary to establish fraud is that

- a. There was a written misrepresentation of fact.
- b. The defendant was in a position of trust and confidence with respect to the plaintiff.
- c. The defendant made a false statement with actual or constructive knowledge of its falsity.
- d. The plaintiff was induced to enter into a contract as the result of an improper threat by the defendant.

N85#15. John Tuck entered into a contract with Jack Doe. Doe asserts that he entered into the contract under duress. Which of the following best describes a necessary element of duress?

- a. There must have been a confidential or fiduciary relationship between Tuck and Doe.
- b. The contract entered into between Tuck and Doe was unconscionable.
- c. Doe entered into the contract with Tuck because of Tuck's improper threats.
- d. Tuck must have intended that Doe be influenced by the improper threats.

M85#23. John Dash, an accountant, entered into a written contract with Kay Reese to perform certain tax services for Reese. Shortly thereafter, Reese was as-

essed additional taxes and she wanted to appeal the assessment. Reese was required to appeal immediately and the workpapers held by Dash were necessary to appeal. Dash refused to furnish Reese with the workpapers unless he was paid a substantially higher fee than was set forth in the contract. Reese reluctantly agreed in order to meet the filing deadline. The contract as revised is

- a. Voidable at Reese's option based on undue influence.
- b. Voidable at Reese's option based on duress.
- c. Void on the ground of undue influence.
- d. Void on the ground of duress.

G. Mistake and Misrepresentation

M89#30. Which of the following remedies is available to a party who has entered into a contract in reliance upon the other contracting party's innocent misrepresentations as to material facts?

	<u>Compensatory damages</u>	<u>Punitive damages</u>	<u>Rescission</u>
a.	No	No	No
b.	Yes	No	Yes
c.	No	No	Yes
d.	Yes	Yes	No

N88#16. On April 6, Apple entered into a signed contract with Bean, by which Apple was to sell Bean an antique automobile having a fair market value of \$150,000, for \$75,000. Apple believed the auto was worth only \$75,000. Unknown to either party the auto had been destroyed by fire on April 4. If Bean sues Apple for breach of contract, Apple's best defense is

- a. Unconscionability.
- b. Risk of loss had passed to Bean.
- c. Lack of adequate consideration.
- d. Mutual mistake.

N87#5. Park entered into a contract to sell Reed a parcel of land. Park was aware that Reed was purchasing the land with the intention of building a high-rise office building. Park was also aware of the fact that a subsurface soil condition would prevent such construction. The condition was extremely unusual and not readily discoverable in the course of normal inspections or soil evaluations. Park did not disclose the existence of the condition to Reed, nor did Reed make any inquiry of Park as to the suitability of the land for the intended development. Park's silence as to the soil condition

- a. Renders the contract voidable at Reed's option.
- b. Entitles Reed only to money damages.
- c. Renders the contract void.
- d. Does **not** affect the validity of the contract.

Business Law

M87#22. Sting Corp., a general contractor, obtained bids from several plumbers to install piping. Lite, a licensed plumber, submitted a bid for \$60,000 which was \$20,000 less than the next lowest bid. Lite made an obvious and substantial arithmetical error in his bid. Sting did not have actual knowledge of Lite's mistake. If Sting accepts Lite's bid, Lite

- a. Must perform the contract for \$60,000 since Sting did **not** have actual knowledge of the error.
- b. Must perform the contract for \$60,000 unless he can show that Sting caused the error.
- c. Can avoid liability for refusing to install the piping for \$60,000 since Sting should have known of Lite's error.
- d. Can avoid liability for refusing to install the piping for \$60,000 only if the error was **not** due to his negligence.

N86

Item 21 is based on the following information:

Bob Meyer sold a parcel of land to Sam Stein for \$85,000. Meyer agreed to accept as payment Stein's promissory note in the amount of \$60,000 and cash of \$25,000. During the course of negotiations Stein misrepresented his financial condition. Furthermore, at the closing Stein made improper threats to Meyer when Meyer indicated he did not want to go through with the deal. As a result of the threats, Meyer did execute and deliver a deed to the land. Meyer wishes to rescind the contract and has commenced an action based upon common law fraud, duress, and innocent misrepresentation. Meyer's complaint contains the following allegations:

- I. Stein materially misrepresented his financial condition.
- II. Stein had actual or constructive knowledge that the representations made during the negotiations were false.
- III. Meyer entered into the contract because of Stein's improper threats.
- IV. Meyer justifiably relied upon Stein's false representations made during the negotiations.
- V. Meyer suffered physical harm as a result of the improper threats.

21. Which statement(s) contained in Meyer's complaint would be necessary to establish the action for innocent misrepresentation?

- a. I and II only.
- b. I, II, and IV.
- c. I and IV only.
- d. IV only.

N85#12. Ted King, a building subcontractor, submitted a bid for construction of a portion of a high-rise office building. The bid contained material errors in

computation. Lago Corp., the general contractor, accepted the bid with knowledge of King's errors. King

- a. Must perform the contract unless he can show that Lago acted fraudulently.
- b. Must perform the contract according to the stated terms since his errors were unilateral.
- c. Will avoid liability on the contract only if his errors were **not** due to his negligence.
- d. Will avoid liability on the contract since Lago knew of King's errors.

M85#19. The primary distinction between an action based on innocent misrepresentation and an action based on common law fraud is that, in the former, a party need **not** allege and prove

- a. That there has been a false representation.
- b. The materiality of the misrepresentation.
- c. Reasonable reliance on the misrepresentation.
- d. That the party making the misrepresentation had actual or constructive knowledge that it was false.

H. Parol Evidence Rule

M89#31. A written agreement was signed by two parties and it was intended to be their entire agreement. The parol evidence rule will prevent the admission of evidence that is offered to

- a. Prove the existence of a contemporaneous oral agreement that modifies the contract.
- b. Prove the existence of a subsequent oral agreement that modifies the contract.
- c. Explain the meaning of an ambiguity in the written contract.
- d. Establish that fraud had been committed in the formation of the contract.

M88#21. Baker and Able signed a contract which required Able to purchase 600 books from Baker at 90¢ per book. Subsequently, Able, in good faith, requested that the price of the books be reduced to 80¢ per book. Baker orally agreed to reduce the price to 80¢. Under the circumstances, the oral agreement is

- a. Unenforceable, because Able failed to give consideration, but proof of it will be otherwise admissible into evidence.
- b. Unenforceable, due to the statute of frauds, and proof of it will be inadmissible into evidence.
- c. Enforceable, but proof of it will be inadmissible into evidence.
- d. Enforceable, and proof of it will be admissible into evidence.

M86#12. Price and White entered into an all-inclusive written contract involving the purchase of a building. Their written agreement contained provisions concerning renovation work to the building to be completed

Selected Questions

by Price. This aspect of the written contract was modified by a contemporaneous oral agreement between the parties. Price relies upon the parol evidence rule to support his position that the written contract is binding on the parties. Which of the following is correct?

- a. Since the statute of frauds was satisfied in respect to the contract for the purchase of the building, the parol evidence rule does **not** apply.
- b. Since the oral agreement related to the same subject matter as the written contract, the parol evidence rule does **not** apply.
- c. White will be precluded from introducing into evidence proof of the oral agreement because of the parol evidence rule.
- d. The parol evidence rule does **not** apply to contemporaneous oral agreements.

M85#25. Where the parties have entered into a written contract intended as the final expression of their agreement, the parol evidence rule generally prevents the admission into evidence of any

- a. Other written agreement which is referred to in the contract.
- b. Contemporaneous oral agreement which explains an ambiguity in the written contract.
- c. Prior oral or written agreement and any contemporaneous oral agreement which contradict the terms of the written contract.
- d. Subsequent oral modification of the contract.

I. Third Party Rights

M89#32. Ace contracted with Big City to train and employ handicapped, unemployed veterans residing in Big City. Ace breached the contract and Bell, a resident of Big City who is a handicapped, unemployed veteran, sues Ace for damages. Under the circumstances, Bell will

- a. Lose, because Bell is merely an incidental beneficiary of the contract.
- b. Win, because Bell is a third-party beneficiary entitled to enforce the contract.
- c. Lose, because Big City did **not** assign its contract rights to Bell.
- d. Win, because the intent of the contract was to confer a benefit on all handicapped, unemployed veterans residing in Big City.

N88#17. Bond purchased from Spear Corp. an apartment building that was encumbered by a mortgage securing Spear's promissory note to Fale Finance Co. Bond assumed Spear's note and mortgage. Subsequently, Bond defaulted on the note payable to Fale and, as a result, the building was sold at a foreclosure sale. If the proceeds of the foreclosure sale are less than the balance due on the note, which of the following statements is correct?

- a. Fale must sue both Spear and Bond to collect the deficiency because they are jointly and severally liable.

- b. Spear will be liable for the deficiency.
- c. Fale must attempt to collect the deficiency from Bond before suing Spear.
- d. Spear will **not** be liable for the deficiency because Bond assumed the note and mortgage.

M87#23. Krieg was the owner of an office building encumbered by a mortgage securing Krieg's promissory note to Muni Bank. Park purchased the building subject to Muni's mortgage. As a result of the sale to Park,

- a. Muni is **not** a third party creditor beneficiary.
- b. Krieg is a third party creditor beneficiary.
- c. Park is liable for any deficiency resulting from a default on the note.
- d. Krieg was automatically released from any liability on the note.

N86#23. Miser Corp. owned a factory which was encumbered by a mortgage securing Miser's note to City Bank. Miser sold the factory to Sting, Inc. which assumed the mortgage note. Subsequently, Sting defaulted on the note which had an outstanding balance of \$15,000. In order to recover the outstanding balance, City

- a. Must sue Sting and Miser.
- b. Must sue Sting first and then proceed against Miser for any deficiency.
- c. May sue Sting or Miser.
- d. May sue Sting only after suing Miser.

M86#13. Barr entered into a contract with Gray which required Gray to construct a warehouse on land owned by Barr. The contract specifically provided for Gray to use Apex Corp. pipe fittings for all the plumbing. Gray failed to use Apex pipe fittings. Apex had learned of the contract between Barr and Gray and, in anticipation of receiving an order from Gray, manufactured additional pipe fittings. Apex is

- a. Entitled to money damages due to Gray's breach of contract.
- b. Entitled to money damages since it changed its position to its detriment by relying on the contract.
- c. Not entitled to money damages since it is merely a donee beneficiary.
- d. Not entitled to money damages since it is merely an incidental beneficiary.

N85

Item 17 is based on the following information:

Sand sold a warehouse he owned to Quick Corp. The warehouse was encumbered by an outstanding mortgage securing Sand's note to Security Bank. Quick assumed the Sand's note and mortgage at the time it purchased the warehouse from Sand. Within three months, Quick defaulted on the note and Security Bank

commenced a mortgage foreclosure action. The proceeds of the resulting foreclosure sale were less than the outstanding balance on the note.

17. As to the contract between Sand and Quick, Security is

- a. A third party creditor beneficiary.
- b. A third party donee beneficiary.
- c. A third party incidental beneficiary.
- d. Not a beneficiary.

M85#26. Fink is the owner of a parcel of land which is encumbered by a mortgage securing Fink's note to State Bank. Fink sold the land to Bloom who assumed the mortgage note. State Bank

- a. Is a donee beneficiary.
- b. Is an incidental beneficiary.
- c. Is a creditor beneficiary.
- d. Can not collect from Fink if Bloom defaults.

J. Assignments

M89#33. Generally, which one of the following transfers will be valid without the consent of the other parties?

- a. The assignment by the lessee of a lease contract where rent is a percentage of sales.
- b. The assignment by a purchaser of goods of the right to buy on credit without giving security.
- c. The assignment by an architect of a contract to design a building.
- d. The assignment by a patent holder of the right to receive royalties.

N88#18. Pix borrowed \$80,000 from Null Bank. Pix gave Null a promissory note and mortgage. Subsequently, Null assigned the note and mortgage to Reed. Reed failed to record the assignment or notify Pix of the assignment. If Pix pays Null pursuant to the note, Pix will

- a. Be primarily liable to Reed for the payments made to Null.
- b. Be secondarily liable to Reed for the payments made to Null.
- c. Not be liable to Reed for the payments made to Null because Reed failed to record the assignment.
- d. Not be liable to Reed for the payments made to Null because Reed failed to give Pix notice of the assignment.

M88#23. Quick Corp. has \$270,000 of outstanding accounts receivable. On March 10, 1988, Quick assigned a \$30,000 account receivable due from Pine, one of Quick's customers, to Taft Bank for value. On March 30, Pine paid Quick the \$30,000. On April 5, Taft notified Pine of the March 10 assignment from Quick to Taft. Taft is entitled to collect \$30,000 from

- a. Either Quick or Pine.
- b. Neither Quick nor Pine.
- c. Pine only.
- d. Quick only.

M87#21. On May 2, Kurtz Co. assigned its entire interest in a \$70,000 account receivable due in 60 days from Long to City Bank for \$65,000. On May 4, City notified Long of the assignment. On May 7, Long informed City that Kurtz had committed fraud in the transaction out of which the account receivable arose and that payment would not be made to City. If City commences an action against Long and Long is able to prove Kurtz acted fraudulently,

- a. Long will be able to successfully assert fraud as a defense.
- b. City will be entitled to collect \$65,000, the amount paid for the assignment.
- c. City will be entitled to collect \$70,000 since fraud in the inducement is a personal defense which was lost on May 2.
- d. City will be entitled to collect \$70,000 since Long's allegation of fraud arose after notice of the assignment.

N86#24. Quick Corp. mailed a letter to Blue Co. on May 1, 1986, offering a three-year franchise dealership. The offer stated the terms in detail and at the bottom stated that the offer would not be withdrawn prior to June 5, 1986. Which of the following is correct?

- a. The offer can **not** be assigned to another party by Blue if Blue chooses **not** to accept.
- b. A letter of acceptance from Blue to Quick sent on June 5, 1986, and which was received by Quick on June 6, 1986, does **not** create a valid contract.
- c. The offer is an irrevocable option which can **not** be withdrawn prior to June 5, 1986.
- d. The statute of frauds does **not** apply to the proposed contract.

N85#6. On May 1, Apple mailed a signed offer to sell an office building to Fein for \$90,000. The offer indicated that it would remain open until May 10. On May 5, Fein assigned the offer to Boyd for \$5,000. On May 8, Boyd orally accepted Apple's offer. Apple refused to sell the building to Boyd. Which of the following statements is correct?

- a. Fein's assignment to Boyd was effective because an option contract was formed between Apple and Fein on May 1.
- b. Fein's assignment to Boyd was effective against Apple because valid consideration was given.
- c. Boyd's acceptance was ineffective because the offer could **not** be assigned.
- d. Boyd's acceptance was ineffective against Apple because it was oral.

M85

Item 22 is based on the following information:

After substantial oral negotiations, Ida Frost wrote Jim Lane on May 1 offering to pay Lane \$160,000 to build a warehouse. The writing contained the terms essential to form a binding contract. It also provided that the offer would remain open until June 1 and that

Selected Questions

acceptance must be received to be effective. On May 20, Lane mailed a signed acceptance. This was received by Frost on May 22. Lane completed the warehouse on July 15. On July 30, Lane assigned his right to receive payment to Reid Bank which did not notify Frost of the assignment. Two weeks later, Frost paid Lane \$155,000 after deducting \$5,000 in satisfaction of a dispute between them unrelated to the construction contract.

22. If Reid sues Frost on the contract, Reid will be entitled to recover
- The full \$160,000.
 - \$160,000, less the \$5,000 setoff.
 - Nothing, because notice of the assignment was **not** given to Frost.
 - Nothing, because it was **not** the primary beneficiary of the construction contract.

K. Discharge, Breach, and Remedies

M89#34. In September 1988, Cobb Company contracted with Thrifty Oil Company for the delivery of 100,000 gallons of heating oil at the price of 75¢ per gallon at regular specified intervals during the forthcoming winter. Due to an unseasonably warm winter, Cobb took delivery on only 70,000 gallons. In a suit against Cobb for breach of contract, Thrifty will

- Lose, because Cobb acted in good faith.
- Lose, because both parties are merchants and the UCC recognizes commercial impracticability.
- Win, because this is a requirements contract.
- Win, because the change of circumstances could have been contemplated by the parties.

M89#35. Jones, CPA, entered into a signed contract with Foster Corp. to perform accounting and review services. If Jones repudiates the contract prior to the date performance is due to begin, which of the following is **not** correct?

- Foster could successfully maintain an action for breach of contract after the date performance was due to begin.
- Foster can obtain a judgment ordering Jones to perform.
- Foster could successfully maintain an action for breach of contract prior to the date performance is due to begin.
- Foster can obtain a judgment for the monetary damages it incurred as a result of the repudiation.

N88#19. Foster Co. and Rice executed a contract by which Foster was to sell a warehouse to Rice for \$270,000. The contract required Rice to pay the entire \$270,000 at the closing. Foster has refused to close the sale of the warehouse to Rice. If Rice commences a

lawsuit against Foster, what relief would Rice likely be entitled to?

- Specific performance or compensatory damages.
- Specific performance and compensatory damages.
- Compensatory damages or punitive damages.
- Compensatory damages and punitive damages.

M88#24. Dell owed Stark \$9,000. As the result of an unrelated transaction, Stark owed Ball that same amount. The three parties signed an agreement that Dell would pay Ball instead of Stark, and Stark would be discharged from all liability. The agreement among the parties is

- A novation.
- An executed accord and satisfaction.
- Voidable at Ball's option.
- Unenforceable for lack of consideration.

N87#1. On June 1, 1986, Nord Corp. engaged Milo & Co., CPAs, to perform certain management advisory services for nine months for a \$45,000 fee. The terms of their oral agreement required Milo to commence performance any time before October 1, 1986. On June 30, 1987, after Milo completed the work to Nord's satisfaction, Nord paid Milo \$30,000 by check. Nord conspicuously marked on the check that it constituted payment in full for all services rendered. Nord has refused to pay the remaining \$15,000 arguing that, although it believes the \$45,000 fee is reasonable, it had received bids of \$30,000 and \$38,000 from other firms to perform the same services as Milo. Milo endorsed and deposited the check. If Milo commences an action against Nord for the remaining \$15,000, Milo will be entitled to recover

- \$0 because there has been an enforceable accord and satisfaction.
- \$0 because the statute of frauds has **not** been satisfied.
- \$8,000 because \$38,000 was the highest other bid.
- \$15,000 because it is the balance due under the agreement.

M87#24. A clause in a contract for the purchase of real estate which provides that the seller shall be entitled to retain the purchaser's down payment as liquidated damages should the purchaser fail to close the transaction will generally be enforceable

- In addition to the seller's right to recover compensatory damages.
- As a penalty if the purchaser has intentionally defaulted.
- If the amount of the down payment bears a reasonable relationship to the probable loss.
- In all cases provided the parties have agreed in a signed writing.

N86#18. Price signed a contract to sell Wyatt a parcel of land for \$90,000. The entire sales price was payable at the closing. Price has decided to keep the land. If Wyatt commences an action against Price, what relief is Wyatt most likely to receive?

- a. Specific performance.
- b. Compensatory damages and specific performance.
- c. Punitive damages.
- d. Compensatory damages and punitive damages.

N86#25. Meek & Co., CPAs, was engaged by Reed, the president of Sulk Corp, to issue by June 15, 1986, an opinion on Sulk's financial statements for the fiscal year ended March 31, 1986. Meek's engagement and its fee of \$20,000 were approved by Sulk's board of directors. Meek did not issue its opinion until June 30 because of Sulk's failure to supply Meek with the necessary information to complete the audit. Sulk refuses to pay Meek. If Meek sues Sulk, Meek will

- a. Prevail based on the contract.
- b. Prevail based on quasi contract.
- c. Lose, since it breached the contract.
- d. Lose, since the June 15 deadline was a condition precedent to Sulk's performance.

M86#9. Ted Nix purchased two acres of land from Sally Pine. Nix paid 15% at the closing and gave his note for the balance secured by a 30-year mortgage. Five years later, Nix found it increasingly difficult to make payments on the note and finally defaulted. Pine threatened to accelerate the loan and foreclose if Nix continued in default. Pine told Nix either to get the money or obtain an acceptable third party to assume the obligation. Nix offered the land to Quick Co. for \$4,000 less than the equity Nix had in the property. This was acceptable to Pine and at the closing Quick paid the arrearage, executed a new mortgage and note, and had title transferred to its name. Pine surrendered Nix's note and mortgage to him. The transaction in question is a(an)

- a. Third party beneficiary contract.
- b. Novation.
- c. Purchase of land subject to a mortgage.
- d. Assignment and delegation.

M86#15. Where the parties to a contract wish to cancel their contract and be in the same position as they were prior to forming the contract, they should seek to obtain a(an)

- a. Rescission.
- b. Novation.
- c. Accord and satisfaction.
- d. Revocation.

N85

Item 18 is based on the following information:

Sand sold a warehouse he owned to Quick Corp. The warehouse was encumbered by an outstanding mortgage securing Sand's note to Security Bank. Quick assumed the Sand's note and mortgage at the time it purchased the warehouse from Sand. Within three months, Quick defaulted on the note and Security Bank commenced a mortgage foreclosure action. The proceeds of the resulting foreclosure sale were less than the outstanding balance on the note.

18. Which of the following statements is correct regarding the rights and liabilities of the parties?

- a. Quick's liability is limited to its equity in the warehouse.
- b. Sand remains liable on the note.
- c. Security must first proceed against Quick to recover the deficiency before seeking payment from Sand.
- d. Sand is **not** liable for the deficiency because Quick assumed the note and mortgage.

M85#27. Bing engaged Dill to perform personal services for \$2,200 a month for a period of four months. The contract was entered into orally on July 1, 1984, and performance was to commence September 1, 1984. On August 10, Dill anticipatorily repudiated the contract. As a result, Bing can

- a. Not assign his rights to damages under the contract to a third party.
- b. Obtain specific performance.
- c. Not enforce the contract against Dill since the contract is oral.
- d. Immediately sue for breach of contract.

Selected Questions

IV. Debtor-Creditor Relationships

A. Suretyship

N88#20. Ford was unable to repay a loan from City Bank when due. City refused to renew the loan to Ford unless an acceptable surety could be provided. Ford asked Owens, a friend, to act as surety on the loan. To induce Owens to agree to become a surety, Ford made fraudulent representations about Ford's financial condition and promised Owens discounts on merchandise sold at Ford's store. Owens agreed to act as surety and the loan was made to Ford. Subsequently, Ford's obligation to City was discharged in Ford's bankruptcy and City wishes to hold Owens liable. Owens may avoid liability

- Because the arrangement was void at the inception.
- If Owens was an uncompensated surety.
- If Owens can show that City Bank was aware of the fraudulent representations.
- Because the discharge in bankruptcy will prevent Owens from having a right of reimbursement.

N88#21. Ott and Bane agreed to act as co-sureties on an \$80,000 loan that Cread Bank made to Dash. Ott and Bane are each liable for the entire \$80,000 loan. Subsequently, Cread released Ott from liability without Bane's consent and without reserving its rights against Bane. If Dash subsequently defaults, Cread will be entitled to collect a maximum of

- \$0 from Bane.
- \$0 from Dash.
- \$40,000 from Bane.
- \$40,000 from Dash.

M88#26. Sklar borrowed \$360,000 from Rich Bank. At Rich's request, Sklar entered into an agreement with Aker, Burke, and Cey to act as co-sureties on the loan. The agreement between Sklar and the co-sureties provided that the maximum liability of each co-surety was: Aker \$72,000, Burke \$108,000, and Cey \$180,000. After making several payments, Sklar defaulted on the loan. The balance was \$240,000. If Cey pays \$180,000 and Sklar subsequently pays \$60,000, what amounts may Cey recover from Aker and Burke?

- \$0 from Aker and \$0 from Burke.
- \$60,000 from Aker and \$60,000 from Burke.
- \$48,000 from Aker and \$72,000 from Burke.
- \$36,000 from Aker and \$54,000 from Burke.

M88#27. Lux Financial Corp. loaned Boe \$100,000. At Lux's request, Boe entered into an agreement with Frey and Harp for them to act as co-sureties on the loan in the amount of \$100,000 each. If Lux releases Harp without the consent of Frey or Boe, and Boe

subsequently defaults, which of the following statements is correct

- Frey will be liable for 50% of the loan balance.
- Lux's release of Harp will have no effect on Boe's and Frey's liability to Lux.
- Boe will be released for 50% of the loan balance.
- Frey will be liable for the entire loan balance.

M87

Items 26 and 27 are based on the following information:

State Bank loaned Barr \$80,000 and received securities valued at \$20,000 from Barr as collateral. At the request of State, Barr entered into an agreement with Rice and Noll to act as co-sureties on the loan. The agreement provided that Rice and Noll's maximum liability would be \$80,000 each.

26. Which of the following defenses asserted by Rice will completely release Rice from liability to State?

- State and Barr entered into a binding agreement to extend the time for payment that increased the sureties' risk and was agreed to without the sureties' consent.
- Fraud by Barr which induced Rice to enter into the surety contract and which was unknown to State.
- Release of Barr's obligation by State without Rice's or Noll's consent but with State's reservation of its rights against Rice.
- Return of the collateral to Barr by State without Rice's or Noll's consent.

27. If State releases Noll without Rice's consent and Barr subsequently defaults at a time when the collateral held by State is worthless and the loan balance is \$80,000, Rice's maximum potential liability will be

- \$0
- \$40,000
- \$60,000
- \$80,000

M87#28. Adler, Field, and Hall are co-sureties with maximum liabilities of \$20,000, \$30,000, and \$40,000, respectively. The amount of the loan with regard to which they have agreed to act as co-sureties is \$90,000. The debtor defaulted at a time when the loan balance was \$90,000. Adler paid the lender \$18,000 in full settlement of all claims against Adler, Field, and Hall. The maximum amount that Adler may recover from Field and Hall in total is

- \$0
- \$12,000
- \$14,000
- \$70,000

Business Law

M87#29. A distinction between a surety and a co-surety is that only a co-surety is entitled to

- a. Contribution.
- b. Exoneration.
- c. Subrogation.
- d. Reimbursement (Indemnification).

N86#26. Which of the following defenses will release a surety from liability?

- a. Release of the principal debtor's obligation by the creditor without the surety's consent but with the creditor's reservation of its rights against the surety.
- b. Modification by the principal debtor and creditor of their contract without the surety's consent which materially increases the surety's risk of loss.
- c. Discharge of the principal debtor in bankruptcy.
- d. Insanity of the principal debtor at the time the contract was entered into with the creditor.

N86#28. Queen paid Pax & Co. to become the surety on a loan which Queen obtained from Squire. The loan is due and Pax wishes to compel Queen to pay Squire. Pax has not made any payments to Squire in its capacity as Queen's surety. Pax will be most successful if it exercises its right to

- a. Reimbursement (Indemnification).
- b. Contribution.
- c. Exoneration.
- d. Subrogation.

N85#32. West promised to make Noll a loan of \$180,000 if Noll obtained sureties to secure the loan. Noll entered into an agreement with Carr, Gray, and Pine to act as co-sureties on his loan from West. The agreement between Noll and the co-sureties provided for compensation to be paid to each of the co-sureties. It further indicated that the maximum liability of each co-surety would be as follows: Carr \$180,000, Gray \$60,000, and Pine \$120,000. West accepted the commitment of the sureties and made the loan to Noll. After paying nine installments totaling \$90,000, Noll defaulted. Gray's debts (including his surety obligation to West on the Noll loan) were discharged in bankruptcy. Subsequently, Carr properly paid the entire debt outstanding of \$90,000. What amounts may Carr recover from the co-sureties?

	<u>Gray</u>	<u>Pine</u>
a.	\$0	\$30,000
b.	\$0	\$36,000
c.	\$15,000	\$30,000
d.	\$30,000	\$30,000

B. Bankruptcy

N88#22. Wilk owes a total of \$25,000 to eight unsecured creditors and one fully secured creditor. Rusk is one of the unsecured creditors and is owed \$7,000.

Rusk has filed a petition against Wilk under the liquidation provisions of the Bankruptcy Code. Wilk has been unable to pay Wilk's debts as they become due and Wilk's liabilities exceed Wilk's assets. Wilk has filed the papers that are required to oppose the bankruptcy petition. Which of the following statements is correct?

- a. The petition will be granted because Wilk is unable to pay Wilk's debts as they become due.
- b. The petition will be granted because Wilk's liabilities exceed Wilk's assets.
- c. The petition will be dismissed because three unsecured creditors must join in the filing of the petition.
- d. The petition will be dismissed because the secured creditor failed to join in the filing of the petition.

N88

Items 23 and 24 are based on the following:

On July 15, 1988, White, a sole proprietor, was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. White's non-exempt property has been converted to \$13,000 cash, which is available to satisfy the following claims:

Unsecured claim for 1986 state income tax	\$10,000
Fee owed to Best & Co., CPAs, for services rendered from April 1, 1988, through June 30, 1988	\$6,000
Unsecured claim by Stieb for wages earned as an employee of White during March, 1988	\$3,000

There are no other claims.

23. What is the maximum amount that will be distributed for the payment of the 1986 state income tax?

- a. \$ 4,000
- b. \$ 5,000
- c. \$ 7,000
- d. \$10,000

24. What is the maximum amount that will be distributed to Stieb?

- a. \$0
- b. \$1,000
- c. \$2,000
- d. \$3,000

N88

Items 25 through 27 are based on the following:

On May 5, 1988, Bold obtained a \$90,000 judgment in a malpractice action against Aker, a physician. On June 2, 1988, Aker obtained a \$75,000 loan from Tint Finance Co. by knowingly making certain false representations to Tint. On July 7, 1988, Aker filed a voluntary

Selected Questions

petition in bankruptcy under the liquidation provisions of the Bankruptcy Code. Both Bold and Tint filed claims in Aker's bankruptcy proceeding. Assets in Aker's bankruptcy estate are exempt.

25. Bold's claim
 - a. Will be excepted from Aker's discharge in bankruptcy.
 - b. Will cause Aker to be denied a discharge in bankruptcy.
 - c. Will be set aside as a preference.
 - d. Will be discharged in Aker's bankruptcy proceeding.

26. Tint's claim
 - a. Will be excepted from Aker's discharge in bankruptcy.
 - b. Will cause Aker to be denied a discharge in bankruptcy.
 - c. Will be set aside as a preference.
 - d. Will be discharged in Aker's bankruptcy proceeding.

27. For this item only, assume that on June 9, 1988, Aker transferred property he owned to his son. The property was collateral for Aker's obligation to Simon. Aker transferred the property with the intent to defraud Simon. Which of the following statements is correct?
 - a. Only Simon's debt will be excepted from Aker's discharge in bankruptcy.
 - b. Aker will be denied a discharge in bankruptcy.
 - c. The transfer will be set aside because it constitutes a preference.
 - d. Aker will receive a discharge in bankruptcy of all debts.

N88#28. The Bankruptcy Code provides that a debtor is entitled to claim as exempt property the right to receive

	<u>Social security benefits</u>	<u>Disability benefits</u>
a.	No	No
b.	Yes	No
c.	Yes	Yes
d.	No	Yes

N88#29. Which of the following statements is correct under the reorganization provisions of the Bankruptcy Code?

- a. The court is required to appoint a trustee or an examiner in all cases.
- b. The creditors must appoint a trustee or an examiner after the bankruptcy petition is filed.
- c. The bankruptcy petition may only be filed voluntarily by the debtor.
- d. The court is required to appoint a committee of unsecured creditors.

M88

Items 28 through 31 are based on the following information:

Knox operates an electronics store as a sole proprietor. On April 5, 1988, Knox was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. On April 20, a trustee in bankruptcy was appointed and an order for relief was entered. Knox's non-exempt property has been converted to cash, which is available to satisfy the following claims and expenses as may be appropriate:

Claims and expenses

Claim by Dart Corp. (one of Knox's suppliers) for computers ordered on April 6, 1988 and delivered on credit to Knox on April 10, 1988.	\$20,000
Fee earned by the bankruptcy trustee.	\$15,000
Claim by Boyd for a deposit given to Knox on April 1, 1988, for a computer Boyd purchased for personal use but that had not yet been received by Boyd.	\$1,500
Claim by Noll Co. for the delivery of stereos to Knox on credit. The stereos were delivered on March 4, 1988, and a financing statement was properly filed on March 5, 1988. These stereos were sold by the trustee with Noll's consent for \$7,500, their fair market value.	\$5,000
Fees earned by the attorneys for the bankruptcy estate.	\$10,000
Claims by unsecured general creditors.	\$1,000

The cash available for distribution includes the proceeds from the sale of the stereos.

28. What amount will be distributed to the trustee as a fee if the cash available for distribution is \$15,000?

- a. \$ 6,000
- b. \$ 9,000
- c. \$10,000
- d. \$15,000

29. What amount will be distributed to Boyd if the cash available for distribution is \$50,800?

- a. \$ 480
- b. \$ 800
- c. \$ 900
- d. \$1,500

30. What amount will be distributed to Dart if the cash available for distribution is \$41,000?

- a. \$10,100
- b. \$11,000
- c. \$16,000
- d. \$20,000

Business Law

31. If the trustee in bankruptcy wishes to avoid Noll's March 4 transaction with Knox as a preferential transfer, the trustee will

- a. Lose, because the transfer was in fact a substantially contemporaneous exchange for new value given.
- b. Lose, because there is **no** evidence that Knox was insolvent on March 4.
- c. Prevail, because the transfer occurred within 90 days of the filing of the bankruptcy petition.
- d. Prevail, because the financing statement was **not** filed on the day of delivery.

M88#32. Which of the following statements is correct with respect to a voluntary bankruptcy proceeding under the liquidation provisions of the Bankruptcy Code?

- a. The debtor must be insolvent.
- b. The liabilities of the debtor must total \$5,000 or more.
- c. It may be properly commenced and maintained by any person who is insolvent.
- d. The filing of the bankruptcy petition constitutes an order for relief.

M88#33. In general, which of the following debts will be discharged under the voluntary liquidation provisions of the Bankruptcy Code?

- a. Debts incurred after the order for relief but before the debtor receives a discharge in bankruptcy.
- b. Income taxes due as the result of filing a fraudulent return seven years prior to the filing of the bankruptcy petition.
- c. A debt arising before the filing of the bankruptcy petition due to the debtor's negligence.
- d. Alimony payments owed to the debtor's spouse under a separation agreement entered into prior to the filing of the bankruptcy question.

M88#34. On June 5, 1987, Green rented equipment under a five-year lease. On March 8, 1988, Green was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code, and a trustee was appointed. The fair market value of the equipment exceeds the balance of the lease payments due. The trustee

- a. Must assume the equipment lease because its term exceeds one year.
- b. Must assume and subsequently assign the equipment lease.
- c. May elect **not** to assume the equipment lease.
- d. May **not** reject the equipment lease because the fair market value of the equipment exceeds the balance of the lease payments due.

M88#35. Which of the following statements is correct with respect to the reorganization provisions of the Bankruptcy Code?

- a. The commencement of a proceeding may be voluntary or involuntary.
- b. A partnership is **not** eligible to be a debtor.
- c. In all cases a trustee must be appointed.
- d. The debtor must be insolvent if the bankruptcy petition was filed voluntarily.

M87

Items 30 and 31 are based on the following information:

On March 10, 1987, Rowe, a sole proprietor selling furniture, was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. Rowe's non-exempt property has been converted to cash which is available to satisfy the following expenses and unsecured claims as may be appropriate:

Expenses

Costs necessary to preserve the property of the debtor's estate	\$20,000
Salary to Rowe for services rendered in operating the furniture business after the commencement of the bankruptcy action	\$10,000

Unsecured Claims

Claims by two of Rowe's employees for wages earned within 90 days of the filing of the bankruptcy petition in the amount of \$4,000 and \$3,000, respectively	\$ 7,000
Claim by Acme Corp. for furniture delivered to Rowe on March 12, 1987, which was prior to the appointment of a trustee and the order for relief	\$30,000

30. What amount will be distributed as salary to Rowe if the cash available for distribution is \$15,000?

- a. \$0
- b. \$ 5,000
- c. \$ 7,500
- d. \$10,000

31. What amount will be distributed to Acme if the cash available for distribution is \$50,000?

- a. \$13,000
- b. \$16,000
- c. \$20,000
- d. \$30,000

Selected Questions

M87#32. Which of the following is correct with respect to an involuntary bankruptcy proceeding under the liquidation provisions of the Bankruptcy Code?

- a. It may be commenced against any debtor who is insolvent.
- b. The debtor may regain possession of property in the possession of an interim trustee if the debtor files a bond.
- c. The petitioners must automatically file a bond to indemnify the debtor for any loss caused by the filing of the petition.
- d. A trustee must be elected by the creditors immediately after the court orders relief against the debtor.

M87#34. One of the elements necessary to establish that a preferential transfer has been made under the Bankruptcy Code by the debtor to a creditor is that the

- a. Debtor was insolvent at the time of the transfer.
- b. Creditor was an insider and the transfer occurred within 90 days of the filing of the bankruptcy petition.
- c. Transfer was in fact a contemporaneous exchange for new value given to the debtor.
- d. Transfer was made by the debtor with actual intent to hinder, delay, or defraud other creditors.

M87#35. Which of the following statements is correct under the Reorganization Chapter of the Bankruptcy Code if the debtor remains in possession of its business?

I. The debtor has the right to be compensated in the same manner as a trustee.

II. The debtor has the right to retain its own accountant to represent it despite the debtor's employment of that accountant prior to the commencement of the Reorganization proceeding.

- a. I only.
- b. II only.
- c. I and II.
- d. Neither I nor II.

N85#26. Lux Corp. has been suffering large losses for the past two years. Because of its inability to meet current obligations, Lux has filed a petition for reorganization under Chapter 11 of the Bankruptcy Code. The reorganization provisions under the Bankruptcy Code

- a. Require that the court appoint a trustee in all cases.
- b. Permit Lux to remain in possession of its assets.
- c. Apply only to involuntary bankruptcy.
- d. Will apply to Lux only if Lux is required to register pursuant to the federal securities laws.

N85#27. Fox, a sole proprietor, has been involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. Sax, CPA, has been

appointed trustee of the debtor's estate. If Sax also wishes to act as the tax return preparer for the estate, which of the following statements is correct?

- a. Sax may employ himself to prepare tax returns if authorized by the court and may receive a separate fee for services rendered in each capacity.
- b. Sax is prohibited from serving as both trustee and preparer under any circumstances since serving in that dual capacity would be a conflict of interest.
- c. Although Sax may serve as both trustee and preparer, he is entitled to receive a fee only for the services rendered as a preparer.
- d. Although Sax may serve as both trustee and preparer, his fee for services rendered in each capacity will be determined solely by the size of the estate.

N85#28. Sly has serious financial problems and is unable to meet current unsecured obligations of \$30,000 to 19 creditors who are demanding immediate payment. Sly owes Kane \$6,500 and Kane has decided to file an involuntary petition in bankruptcy against Sly. Which of the following is necessary in order for Kane to validly petition Sly into bankruptcy?

- a. Kane must allege and establish that Sly's liabilities exceed the fair market value of Sly's assets.
- b. Kane must be joined by at least two other creditors.
- c. Sly must have committed an act of bankruptcy within 120 days of the filing.
- d. Kane must be a secured creditor.

N85#29. A bankrupt who has voluntarily filed for and received a discharge in bankruptcy under the liquidation provisions (Ch. 7)

- a. Is precluded from owning or operating a similar business for two years.
- b. Must surrender for distribution to the creditors amounts received as an inheritance if the receipt occurs within 180 days after filing of the petition.
- c. Will receive a discharge of any and all debts owed by him as long as he has **not** committed a bankruptcy offense.
- d. Can obtain another voluntary discharge in bankruptcy under Ch. 7 after five years have elapsed from the date of the prior filing.

N85#30. Which of the following will **not** be discharged in a bankruptcy proceeding?

- a. Claims resulting out of an extension of credit based upon false representations.
- b. Claims of secured creditors which remain unsatisfied after their receipt of the proceeds from the disposition of the collateral.
- c. Claims for unintentional torts which resulted in bodily injury to the claimant.
- d. Claims arising out of the breach of a contract by the debtor.

V. Government Regulation of Business

A. Regulation of Employment

M89#36. The Federal Unemployment Tax Act

- a. Imposes a tax on all employers doing business in the U.S.
- b. Requires contributions to be made by the employer and employee equally.
- c. Allows an employer to take a credit against the federal unemployment tax if contributions are made to a state unemployment fund.
- d. Permits an employee to receive unemployment benefits that are limited to the contributions made to that employee's account.

M89#37. Under the Federal Insurance Contributions Act (FICA) and the Social Security Act (SSA),

- a. Persons who are self-employed are **not** required to make FICA contributions.
- b. Employees who participate in private retirement plans are **not** required to make FICA contributions.
- c. Death benefits are payable to an employee's survivors only if the employee dies before reaching the age of retirement.
- d. The receipt of earned income by a person who is also receiving social security retirement benefits may result in a reduction of such benefits.

M89#38. Which one of the following statements concerning workers' compensation laws is generally correct?

- a. Workers' compensation laws are very narrowly construed against employees.
- b. The amount of damages recoverable is based on comparative negligence.
- c. Employers are strictly liable without regard to whether or not they are at fault.
- d. Workers' compensation benefits are **not** available if the employee is grossly negligent.

N88#30. Which of the following statements is correct with respect to social security taxes and benefits?

- a. A self-employed individual with net earnings of \$35,000 will pay more tax than an employee with wages of \$35,000.
- b. Both employees and self-employed individuals are subject to social security taxes based on their respective gross wages or gross earnings from self-employment.

- c. To the extent the amount received as retirement benefits is less than the amount contributed to the social security fund by the individual, it will **never** be included in the individual's adjusted gross income for federal income tax purposes.
- d. An individual whose gross income exceeds certain maximum limitations is required to include the entire amount received as disability benefits in the computation of the individual's adjusted gross income for federal income tax purposes.

M88#43. Which of the following statements is correct with respect to social security taxes and benefits?

- a. An individual whose gross income exceeds certain maximum limitations is required to include the entire amount received as disability benefits in the computation of taxable income.
- b. Benefits are available to a qualifying individual or that individual's family only upon retirement or disability.
- c. An employer that erroneously underwithholds and underpays an employee's share of social security taxes will be liable for the unpaid balance of the employee's share.
- d. An individual whose private pension benefits exceed certain maximum limitations will have social security retirement benefits reduced.

M88#44. Bing was employed as a taxi driver by Speedy, Inc. While acting in the scope and course of his employment with Speedy, Bing collided with a van driven by Hart. Hart was an independent contractor making a delivery for Troy Corp. The collision was caused solely by Bing's negligence. As a result of the collision, both Bing and Hart suffered permanent injuries. Speedy and Troy were both in compliance with the state's workers' compensation statute. If Hart commences an action against Bing and Speedy for negligence, which of the following statements is correct?

- a. Hart is entitled to recover damages from Bing or Speedy.
- b. Bing will either be denied workers' compensation benefits or have his benefits reduced because of his negligence.
- c. Hart's action for negligence will be dismissed because Hart is an independent contractor.
- d. Hart is entitled to recover damages from Speedy's workers' compensation carrier to the extent **no** duplicate payment has been received by Hart.

Selected Questions

M88#45. In general, which of the following statements is correct with respect to unemployment compensation?

- a. An employee who is unable to work because of a disability is entitled to unemployment compensation.
- b. An individual who has been discharged from employment because of work-connected misconduct is ineligible for unemployment compensation.
- c. The maximum period during which unemployment compensation may be collected is uniform throughout the United States.
- d. The maximum amount of weekly unemployment compensation payments made by a state is determined by federal law.

N87

Items 13 and 14 are based on the following information:

During the calendar year 1987, Nix estimates having \$5,000 of gross earnings from self-employment and \$4,800 of allowable deductions attributable to such income. Nix expects to earn the self-employment income as a sole proprietor rendering management advisory services.

13. For this question only, if Nix receives in 1987 wages of \$40,000 as an employee of Pace Corp., the amount of self-employment earnings subject to social security taxes would be

- a. \$0
- b. \$ 200
- c. \$3,800
- d. \$5,000

14. For this question only, if Nix receives in 1987 wages of \$5,000, the amount of self-employment earnings subject to the federal unemployment tax would be

- a. \$0
- b. \$ 200
- c. \$3,800
- d. \$5,000

N87#15. In general, which of the following is **not** an available method of complying with a state's workers' compensation statute for a private employer?

- a. Self-insurance by the employer.
- b. Participation in the state insurance fund.
- c. Participation in a federal insurance fund.
- d. Purchase of insurance from a private insurer.

M87#36. Nix, an employee of Fern, Inc., was injured in the course of employment while operating a drill press manufactured and sold to Fern by Jet Corp. It has been determined that Fern was negligent in super-

vising the operation of the drill press and that the drill press was defectively designed by Jet. If Fern has complied with the state's mandatory workers' compensation statute, Nix may

- a. Not properly commence a products liability action against Jet.
- b. Not obtain workers' compensation benefits.
- c. Obtain workers' compensation benefits and properly maintain a products liability action against Jet.
- d. Obtain workers' compensation benefits and properly maintain separate causes of action against Jet and Fern for negligence.

M87#37. The social security tax base is calculated on

- a. A self-employed person's net profit from self-employment.
- b. A self-employed person's gross income from self-employment.
- c. An employee's gross wages less the deduction permitted for contributions to an individual retirement account.
- d. An employee's taxable income.

N86#37. Which of the following is correct with respect to the Federal Unemployment Tax Act?

- a. Employees who earn less than \$7,000 are exempt from coverage.
- b. Payment of the tax is shared equally by the employer and the employee.
- c. A credit is generally available for contributions made by the employer to state unemployment funds.
- d. Benefits to an employee can **not** exceed the amount contributed to his account.

N86#38. While in the course of employment with Marco, Inc., Payne was injured. Marco has complied with the state's mandatory workers' compensation statute. Marco's workers' compensation carrier has asserted the following defenses to Payne's claim for workers' compensation benefits:

- I. Marco was free from any wrongdoing.
- II. Payne assumed the risk by disregarding Marco's safety procedures.
- III. Payne's injury was intentionally self-inflicted.

Which defense(s) asserted by the workers' compensation carrier, if proven, will prevent Payne from recovering?

- a. I only.
- b. II only.
- c. III only.
- d. I or II.

Business Law

- N86#39.** Social security benefits may be obtained by
- Qualifying individuals who are also receiving benefits from a private pension plan.
 - Qualifying individuals or their families only upon such individual's disability or retirement.
 - Children of a deceased worker who was entitled to benefits until such children reach age 25 or complete their education, whichever occurs first.
 - Only those individuals who have made payments while employed.

M86#16. With respect to federal unemployment taxes and unemployment compensation, which of the following statements is correct?

- The Federal Unemployment Tax Act requires both the employer and employee to make payments to an approved state unemployment fund.
- Federal unemployment taxes are offset by a credit equal to the amount the employer contributes to an approved state unemployment fund.
- Unemployment compensation received in excess of the employer's contributions is, in all cases, fully includable in the recipient's gross income for federal income tax purposes.
- Payments made by a corporate employer for federal unemployment taxes are deductible as a business expense for federal income tax purposes.

M86#17. Farr, an employee of Sand Corp., was involved in an accident with Wohl, an independent contractor. Wohl was making a delivery for Byrd Corp. when Farr negligently passed through a red light resulting in the accident and injuries to Wohl and Farr. The accident occurred during Farr's regular working hours and in the course of Farr's employment. If Sand and Byrd have complied with the state's workers' compensation laws, which of the following is correct?

- Farr will either be denied workers' compensation benefits or have his benefits reduced due to his negligence.
- Farr will be denied workers' compensation benefits since Sand was free from any wrongdoing.
- Wohl will be denied workers' compensation benefits under Sand's or Byrd's workers' compensation policy.
- Wohl will be denied workers' compensation benefits due to the fellow-servant rule.

M86#18. Which of the following statements is correct regarding social security benefits?

- Retirement benefits paid in excess of the recipient's contributions will be included in the determination of the recipient's federal taxable income regardless of his gross income.

- Upon the death of the recipient, immediate family members within certain age limits are entitled to a death benefit equal to the unpaid portion of the deceased recipient's contributions.
- Retirement benefits are fully includable in the determination of the recipient's federal taxable income if his gross income exceeds certain maximum limitations.
- Individuals who have made **no** contributions may be eligible for some benefits.

N85#21. Fred Gray, an employee of Gold Transport Corp., was injured when the corporate truck which he was driving struck a tree. The state in which Gold was incorporated and operated its business had a compulsory workers' compensation law. Gray will likely receive workers' compensation benefits despite the fact he

- Was properly excluded from coverage under the compulsory workers' compensation law.
- Was driving the truck outside the course of his employment at the time of the accident.
- Intentionally drove the truck into the tree.
- Was negligent by failing to adhere to Gold's safety procedures while operating the truck.

N85#22. Jay White, an engineer, entered into a contract with Sky, Inc., agreeing to provide Sky with certain specified consulting services. After performing the services, White was paid pursuant to the contract but social security taxes were not withheld from his check since Sky considered White an independent contractor. The IRS has asserted that White was an employee and claims that a deficiency exists due to Sky's failure to withhold and pay social security taxes. Which of the following factors is most likely to support the IRS's position that White is an employee?

- White was paid in one lump sum after all the services were performed.
- White provided his own office and supplies.
- Sky supervised and controlled the manner in which White performed the services.
- Sky reserved the right to inspect White's work.

M85#30. Silk was employed by Rosco Corp. as a chauffeur. While in the course of employment, Silk was involved in an automobile accident with Lake who was employed by Stone Corp. as a truck driver. While making a delivery for Stone, Lake negligently drove through a red light causing the accident with Silk. Both Silk and Lake have received workers' compensation benefits as a result of the accident. Silk

- Is precluded from suing Lake since both are covered under workers' compensation laws.
- Is precluded from suing Stone if Stone complied fully with the state's workers' compensation laws.

Selected Questions

- c. Can recover in full against Lake only, but must reimburse the workers' compensation carrier to the extent the recovery duplicates benefits already obtained under workers' compensation laws.
- d. Can recover in full against Lake or Stone, but must reimburse the workers' compensation carrier to the extent the recovery duplicates benefits already obtained under workers' compensation laws.

B. Federal Securities Acts

M89#39. With regard to an offering of common stock requiring registration under the Securities Act of 1933,

- a. The SEC will attempt to pass on the investment value of the common stock before approving the offering.
- b. The registration statement is automatically effective when filed with the SEC.
- c. The issuer may make sales 10 days after filing the registration statement.
- d. The issuer would act unlawfully if it were to sell the common stock without providing the investor with a prospectus.

M89#40. Acme Corp. intends to make a public offering in several states of 250,000 shares of its common stock. Under the Securities Act of 1933,

- a. Acme must sell the common stock through licensed securities dealers.
- b. Acme must, in all events, file a registration statement with the SEC because the offering will be made in several states.
- c. Acme's use of any prospectus delivered to an unsophisticated investor must be accompanied by a simplified explanation of the offering.
- d. Acme may make an oral offer to sell the common stock to a prospective investor after a registration statement has been filed but before it becomes effective.

M89#41. Pace Corp. previously issued 300,000 shares of its common stock. The shares are now actively traded on a national securities exchange. The original offering was exempt from registration under the Securities Act of 1933. Pace has \$2,500,000 in assets and 425 shareholders. With regard to the Securities Exchange Act of 1934, Pace is

- a. Required to file a registration statement because its assets exceed \$2,000,000 in value.
- b. Required to file a registration statement even though it has fewer than 500 shareholders.
- c. Not required to file a registration statement because the original offering of its stock was exempt from registration.
- d. Not required to file a registration statement unless insiders own at least 5% of its outstanding shares of stock.

M89#42. Rice, Inc. is a reporting company under the Securities Exchange Act of 1934. The only security it has issued is its voting common stock. Which one of the following statements is correct?

- a. Any person who owns more than 5% of Rice's common stock must file a report with the SEC.
- b. Rice need **not** file its proxy statements with the SEC because it has only one class of stock outstanding.
- c. It is unnecessary for the required annual report (Form 10-K) to include audited financial statements.
- d. Because Rice is a reporting company, it is **not** required to file a registration statement under the Securities Act of 1933 for any future offerings of its common stock.

M89#43. Which of the following securities is exempt from registration under the Securities Act of 1933?

- a. A class of shares of stock given in exchange for another class by the issuer to its existing shareholders without payment of a commission.
- b. Limited partnership interests sold for the purpose of acquiring funds to invest in bonds issued by the United States.
- c. Corporate debentures that were previously subject to an effective registration statement, provided they are convertible into shares of common stock.
- d. Shares of common stock, provided their par value is less than \$1.00 and they are nonvoting.

M89

Items 44 and 45 are based on the following:

Maco Limited Partnership intends to sell \$6,000,000 of its limited partnership interests. The state in which Maco was organized is also the state in which it carries on all of its business activities.

44. If Maco intends to offer the limited partnership interests in reliance on Rule 147, the intrastate registration exception under the Securities Act of 1933, which one of the following statements is correct?

- a. Maco may make up to five offers to nonresidents without the offering being ineligible for the Rule 147 exemption.
- b. The offering is **not** exempt under Rule 147 because it exceeds \$5,000,000.
- c. Under Rule 147, certain restrictions apply to resales of the limited partnership interests by purchasers.
- d. Rule 147 limits to 100 the number of purchasers of the limited partnership interests.

45. If Maco intends to offer the limited partnership interests in reliance on Rule 506 of Regulation D under the Securities Act of 1933 to prospective investors residing in several states, which of the following statements is correct?

- The offering will be exempt from the anti-fraud provisions of the Securities Exchange Act of 1934.
- Any subsequent resale of a limited partnership interest by a purchaser will be exempt from registration.
- Maco may make an unlimited number of offers to sell the limited partnership interests.
- No more than 35 purchasers may acquire the limited partnership interests.

N88#31. Which of the following facts will result in an offering of securities being exempt from registration under the Securities Act of 1933?

- The sale or offer to sell the securities is made by a person other than an issuer, underwriter, or dealer.
- The securities are non-voting preferred stock.
- The issuing corporation was closely held prior to the offering.
- The securities are AAA-rated debentures that are collateralized by first mortgages on property that has a market value of 200% of the offering price.

N88#32. A plaintiff wishes to recover damages from the issuer for losses resulting from material misstatements in a securities registration statement. In order to be successful, one of the elements the plaintiff must prove is that the

- Plaintiff was in privity of contract with the issuer or that the issuer knew of the plaintiff.
- Plaintiff acquired the securities.
- Issuer acted negligently.
- Issuer acted fraudulently.

N88#33. Which of the following statements is correct concerning corporations subject to the reporting requirements of the Securities Exchange Act of 1934?

- The annual report (form 10-K) need **not** include audited financial statements.
- The annual report (form 10-K) must be filed with the SEC within 20 days of the end of the corporation's fiscal year.
- A quarterly report (form 10-Q) need only be filed with the SEC by those corporations that are also subject to the registration requirements of the Securities Act of 1933.
- A monthly report (form 8-K) must be filed with the SEC after the end of any month in which a materially important event occurs.

N88#34. Which of the following is a security that is exempt from the registration requirements of the Securities Act of 1933?

- Convertible, subordinated debentures issued by a manufacturing company.
- Warrants to purchase preferred stock.
- Bonds issued by a charitable foundation.
- Common stock with a par value of less than \$1.00.

N88#36. The principal purpose of the registration requirements of the Securities Act of 1933 is to

- Prevent public offerings of securities in which management fraud or unethical conduct is suspected.
- Provide the SEC with the information necessary to determine the accuracy of the facts presented in the financial statements.
- Assure that investors have adequate information upon which to base investment decisions.
- Provide the SEC with the information necessary to evaluate the financial merits of the securities being offered.

N88#37. Unless an exemption applies to an offering of securities, the Securities Act of 1933 requires preparation and filing of a

	<u>Registration statement</u>	<u>Prospectus</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N88#38. Which of the following statements is correct with respect to the Securities Exchange Act of 1934?

- Issuers whose securities are registered under the Act are required to comply with its reporting requirements.
- The Act applies only to issuers whose securities are traded on a national securities exchange.
- The Act subjects all issuers of securities to its registration requirements if the issuer has more than \$2.5 million of assets or more than 250 shareholders.
- The antifraud provisions of the Act do **not** apply to issuers of securities that are exempt from the Act's registration requirements.

N88#39. In order to raise \$375,000, Penn Corp. is offering its securities under Rule 504 of Regulation D of the Securities Act of 1933. Under Rule 504, the offering

- Must be sold to accredited investors.
- Can **not** be sold to more than 35 non-accredited investors.

Selected Questions

- c. Can be sold to an unlimited number of accredited and non-accredited investors.
- d. Will **not** subject the issuer to the antifraud provisions of the Securities Act of 1933.

M88#40. If securities are registered under the Securities Exchange Act of 1934, which of the following disclosure provisions apply?

	<i>Notice of sales of the registered securities by the corporation's officers must be filed with the SEC</i>	<i>Proxy material for the registered securities must be filed with the SEC</i>
a.	No	Yes
b.	Yes	No
c.	Yes	Yes
d.	No	No

M88#41. Which of the following are exempt from the registration requirements of the Securities Act of 1933?

- a. All industrial development bonds issued by municipalities.
- b. Stock of a corporation offered and sold only to residents of the state in which the issuer was incorporated and doing all of its business.
- c. Bankers' acceptances with maturities at the time of issue ranging from one to two years.
- d. Participation interests in a money market fund that consists wholly of short-term commercial paper.

M88#42. In general, the Securities Act of 1933 provides for an exemption from registration for

	<i>A stock dividend issued to existing shareholders</i>	<i>Bonds issued by a municipality for governmental purposes</i>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

N87#6. In general, which of the following is **least** likely to be considered a security under the Securities Act of 1933?

- a. General partnership interests.
- b. Warrants.
- c. Limited partnership interests.
- d. Treasury stock.

N87#8. After the filing of the registration statement with the SEC but prior to the effective date, the underwriter is allowed to do which of the following?

- I. Make oral offers to sell the security.
- II. Issue a preliminary prospectus ("red herring").

- a. I only.
- b. II only.
- c. I and II.
- d. Neither I nor II.

N87#9. Rey Corp.'s management intends to solicit proxies relating to its annual meeting at which directors will be elected. Rey is subject to the registration and reporting requirements of the Securities Exchange Act of 1934. As a result, Rey must furnish its shareholders with

- a. A copy of its registration statement and by-laws.
- b. A preliminary copy of its proxy statement at the same time it is filed with the SEC.
- c. An annual report containing its audited statements of income for the five most recent years.
- d. An annual report containing its audited balance sheets for the two most recent years.

N87#10. Pix is offering to issue \$10 million of its securities pursuant to Regulation D of the Securities Act of 1933. Under the applicable provisions of Regulation D,

- a. Each investor must be an accredited investor.
- b. Pix may make a general solicitation in connection with the offering.
- c. The securities may be debentures.
- d. Pix must be a corporation.

N87#11. Harp Corp. is offering to issue \$450,000 of its securities pursuant to Regulation D of the Securities Act of 1933. Harp is not required to deliver a disclosure document in the states where the offering is being conducted. The exemption for small issues of \$500,000 or less (Rule 504) under Regulation D

- a. Requires that the issuer be subject to the reporting requirements of the Securities Exchange Act of 1934.
- b. Does **not** require that any specific information be furnished to investors.
- c. Permits the use of general solicitation.
- d. Requires that each investor be a sophisticated investor or be represented by a purchaser representative.

N87#12. The reporting requirements of the Securities Exchange Act of 1934 and its rules

- a. Apply only to issuers, underwriters, and dealers.
- b. Apply to a corporation that registered under the Securities Act of 1933 but that did **not** register under the Securities Exchange Act of 1934.
- c. Require all corporations engaged in interstate commerce to file an annual report.
- d. Require all corporations engaged in interstate commerce to file quarterly audited financial statements.

Business Law

M87#39. Which of the following statements is correct with respect to the registration requirements of the Securities Exchange Act of 1934?

- a. They require issuers of non-exempt securities traded on a national securities exchange to register with the SEC.
- b. They permit issuers who comply with the Securities Act of 1933 to avoid the registration requirements of the Securities Exchange Act of 1934.
- c. They permit issuers who comply with those requirements to avoid state registration requirements.
- d. They permit issuers who comply with those requirements to avoid the registration requirements of the Securities Act of 1933.

M87#40. On May 1, Apel purchased 7% of Stork Corp.'s preferred stock which was traded on a national securities exchange. After the purchase Apel owned 9% of the outstanding preferred stock. Stork is registered under the Securities Exchange Act of 1934. With respect to the purchase, Apel

- a. Is **not** required to file any report or information with the SEC since Apel owns less than 10% of the preferred stock.
- b. Is **not** required to file any report or information with the SEC since the security purchased was preferred stock.
- c. Must file with the SEC, the issuer, and the national securities exchange information concerning the purpose of the acquisition.
- d. Must file only with the SEC information concerning the source of the funds used to purchase the preferred stock.

M87#41. The registration requirements of the Securities Act of 1933 apply to

- a. The issuance of a stock dividend without commissions or other consideration paid.
- b. The issuance of stock warrants.
- c. Securities issued by a federally chartered savings and loan association.
- d. Securities issued by a common carrier regulated by the Interstate Commerce Commission.

M87#42. Which of the following persons is **not** an insider of a corporation subject to the Securities Exchange Act of 1934 registration and reporting requirements?

- a. The president.
- b. A member of the board of directors.
- c. A shareholder who owns 8% of the outstanding common stock and whose wife owns 4% of the outstanding common stock.
- d. An owner of 15% of the total face value of the corporation's outstanding debentures.

M87#44. Pate Corp. is offering \$3 million of its securities solely to accredited investors pursuant to Regulation D of the Securities Act of 1933. Under Regulation D, Pate is

- a. Not required to provide any specified information to the accredited investors.
- b. Required to provide the accredited investors with audited financial statements for the two most recent fiscal years.
- c. Permitted to make a general solicitation.
- d. Not subject to the antifraud provisions of the federal securities laws.

M87#45. Regulation D of the Securities Act of 1933 is available to issuers without regard to the dollar amount of an offering only when the

- a. Purchasers are all accredited investors.
- b. Number of purchasers who are non-accredited is 35 or less.
- c. Issuer is **not** a reporting company under the Securities Exchange Act of 1934.
- d. Issuer is **not** an investment company.

N86#31. Under the Securities Act of 1933, the registration of securities which are offered to the public in interstate commerce is

- a. Directed toward preventing the marketing of securities which pose serious financial risks to the prospective investor.
- b. Not required unless the issuer is a corporation.
- c. Mandatory unless the cost to the issuer is "prohibitive" as defined in the SEC regulations.
- d. Required unless there is an applicable exemption.

N86#32. Donn & Co. is considering the sale of \$11 million of its common stock to the public in interstate commerce. In this connection, Donn has been correctly advised that registration of the securities with the SEC is

- a. Not required if the states in which the securities are to be sold have securities acts modeled after the federal act and Donn files in those states.
- b. Required in that it is necessary for the SEC to approve the merits of the securities offered.
- c. Not required if the securities are to be sold through a registered brokerage firm.
- d. Required and must include audited financial statements as an integral part of its registration.

N86#33. Tulip Corp. is a registered and reporting corporation under the Securities Exchange Act of 1934. As such it

- a. Can offer and sell its securities to the public without the necessity of registering its securities pursuant to the Securities Act of 1933.

Selected Questions

- b. Can **not** make a tender offer for the equity securities of another registered and reporting corporation without the consent of the SEC.
- c. Must file annual reports (Form 10-K) with the SEC.
- d. Must distribute a copy of the annual report (Form 10-K) to each of its shareholders.

N86#34. One of the clients of Sherman & Pryor, CPAs, plans to form a limited partnership and offer to the public in interstate commerce 2,000 limited partnership units at \$5,000 per unit. Which of the following is correct?

- a. The dollar amount in question is sufficiently small so as to provide an absolute exemption from the Securities Act of 1933.
- b. The Securities Act of 1933 requires a registration despite the fact that the client is **not** selling stock and the purchasers have limited liability.
- c. Under the Securities Act of 1933, Sherman & Pryor has **no** responsibility for financial statements since the limited partnership is a new entity.
- d. Sherman & Pryor may disclaim any liability under the federal securities acts by an unambiguous, bold-faced disclaimer of liability on its audit report.

N86#35. The Securities Exchange Act of 1934

- a. Applies exclusively to issuers whose securities are listed on an organized stock exchange.
- b. Has **no** application to issuers who are **not** required to register.
- c. Imposes additional requirements on those issuers who must register and report.
- d. Requires registration and reporting by all issuers with \$2 million or more of assets or which have 1,000 or more shareholders.

M86#19. A primary purpose of the registration requirements of the Securities Act of 1933 is to

- a. Ensure investors receive fair value for their investments.
- b. Provide investors with information concerning a public offering of securities so that they can make informed investment decisions.
- c. Detect and prevent a public offering of securities where management fraud and unethical conduct is suspected to be present.
- d. Prevent the offering of securities considered to be unsound.

M86#20. A requirement of a private action to recover damages for violation of the registration requirements of the Securities Act of 1933 is that

- a. The securities be purchased from an underwriter.

- b. A registration statement has been filed.
- c. The issuer or other defendants commit either negligence or fraud in the sale of the securities.
- d. The plaintiff has acquired the securities in question.

M86#21. Which of the following provisions of the Securities Exchange Act of 1934 applies despite the fact that a corporation's securities are exempt from registration?

- a. The anti-fraud provisions.
- b. The provisions dealing with the filing of periodic and annual reports.
- c. The proxy provisions.
- d. The provisions imposing internal accounting controls.

M86#22. Regulation D under the Securities Act of 1933

- a. Eliminates all small offerings made pursuant to Regulation A of the Securities Act of 1933.
- b. Permits an exempt offering by a corporation even though it is a "reporting" corporation under the Securities Exchange Act of 1934.
- c. Is limited to offers and sales of common stock which do **not** exceed \$5 million.
- d. Is exclusively available to "small business corporations" as defined by Regulation D.

M86#24. Dee is the owner of 12% of the shares of common stock of D & M Corporation which she acquired in 1975. She is the treasurer and a director of D & M. The corporation registered its securities in 1984 and made a public offering pursuant to the Securities Act of 1933. If Dee decides to sell part of her holdings in D & M, the shares

- a. Would be exempt from registration since the corporation previously registered them within three years.
- b. Must be registered regardless of the amount sold or manner in which they are sold.
- c. Would be exempt from registration because she is **not** an issuer.
- d. Must be registered if Dee sells 50% of her shares through her broker to the public.

M86#25. Which of the following classes of securities or types of transactions are exempt from registration under the Securities Act of 1933?

- a. Transactions by any person other than an issuer, underwriter, or dealer.
- b. The sale of securities by a "control person."
- c. Non-voting, non-cumulative preferred stock.
- d. Collateralized bonds of public utilities.

VI. Uniform Commercial Code

A. Commercial Paper

M89#46. On April 2, 1989, Harris agreed to sell a computer to Cross for \$390. At the time of delivery, Cross gave Harris \$90 and a written instrument, signed by Cross, in which Cross promised to pay Harris the balance on April 20, 1989. The instrument also made a reference to the sale of the computer. Under the UCC Commercial Paper Article, the instrument is a

- Promissory note.
- Non-negotiable draft.
- Trade acceptance.
- Negotiable time draft.

M89#48. The following instrument is in the possession of Bill North:

On May 30, 1989, I promise to pay Bill North, the bearer of this document, \$1,800.

Joseph Peppers
Joseph Peppers

Re: Auto Purchase Contract

This instrument is

- Non-negotiable because it is undated.
- Non-negotiable because it is not payable to order or bearer.
- Negotiable even though it makes reference to the contract out of which it arose.
- Negotiable because it is payable at a definite time.

M89#49. Which one of the following aspects of an otherwise negotiable promissory note will render it non-negotiable?

- The maker is obligated to pay a sum certain to the payee but may instead deliver to the payee goods of equal value.
- The maker has the right to prepay the note, subject to a prepayment penalty of 10% of the amount prepaid.
- The maker is obligated to pay the payee's costs of collection upon default by the maker.
- The maker intentionally using a rubber stamp to sign the note.

M89#50. The following indorsements appear on the back of a negotiable promissory note made payable "to bearer." The note is in the possession of James Mix.

Pay to John Jacobs

Mary Nash
John Jacobs
(without recourse)

Which one of the following statements is correct?

- Mix is not a holder because Jacobs' qualified indorsement makes the note non-negotiable.
- Mix can negotiate the note by delivery alone.
- The unqualified indorsement of Mix is required in order to further negotiate the note.
- In order for Mix to negotiate the note Mix must have given value for it.

M89#51. To the extent that a holder of a negotiable promissory note is a holder in due course, the holder takes the note free from which of the following defenses?

- Non-performance of a condition precedent.
- Discharge of the maker in bankruptcy.
- Minority of the maker where it is a defense to enforcement of a contract.
- Forgery of the maker's signature.

M89#52. Jim Bass is in possession of a negotiable promissory note made payable "to bearer." Bass acquired the note from Mary Frank for value. The maker of the note was Fred Jackson. The following indorsements appear on the back of the note:

Sam Peters
Pay to Jim Bass
Mary Frank
Jim Bass
(without recourse)

Bass presented the note to Jackson, who refused to pay it because he was financially unable to do so. Which of the following statements is correct?

- Peters is not secondarily liable on the note because his indorsement was unnecessary for negotiation.
- Peters is not secondarily liable to Bass.


Selected Questions

- c. Frank will probably **not** be liable to Bass unless Bass gives notice to Frank of Jackson's refusal to pay within a reasonable time.
- d. Bass would have had secondary liability to Peters and Frank if he had **not** qualified his indorsement.

M89#59. A trade acceptance usually

- a. Is an order to deliver goods to a named person.
- b. Provides that the drawer is also the payee.
- c. Is **not** regarded as commercial paper under the UCC.
- d. Must be made payable "to the order of" a named person.

N88#35. Gold is holding the following instrument:

To: Sussex National Bank Suffolk, N.Y.		October 15, 1988
Pay to the order of <u>Tom Gold</u>	<u>\$2,000.00</u>	
<u>Two Thousand and xx/100</u>	Dollars	
<u>on November 1, 1988</u>		
 Lester Davis		

This instrument is a

- a. Postdated check.
- b. Draft.
- c. Promissory note.
- d. Trade acceptance.

N88#36. A bank issues a negotiable instrument that acknowledges receipt of \$50,000. The instrument also provides that the bank will repay the \$50,000 plus 8% interest per annum to the bearer 90 days from the date of the instrument. The instrument is a

- a. Certificate of deposits.
- b. Time draft.
- c. Trade or banker's acceptance.
- d. Cashier's check.

N88#37. Which of the following would cause a promissory note to be nonnegotiable?

- a. An acceleration clause that allows the holder to move up the maturity date of the note in the event of default.

- b. An extension clause that allows the maker to elect to extend the time for payment to a date specified in the note.
- c. A clause that allows the maker to satisfy the note by the performance of services or the payment of money.
- d. A due date is **not** specified in the note.

N88#38. A secured promissory note would be non-negotiable if it provided that

- a. Additional collateral must be tendered if there is a decline in market value of the original collateral.
- b. Upon default, the maker waives a trial by jury.
- c. The maker is entitled to a 5% discount if the note is prepaid.
- d. It is subject to the terms of the mortgage given by the maker to the payee.

N88#39. In general, which of the following statements is correct concerning the priority among checks drawn on a particular account and presented to the drawee bank on a particular day?

- a. The checks may be charged to the account in any order convenient to the bank.
- b. The checks may be charged to the account in any order provided **no** charge creates an overdraft.
- c. The checks must be charged to the account in the order in which the checks were dated.
- d. The checks must be charged to the account in the order of lowest amount to highest amount to minimize the number of dishonored checks.

N88#40. A purchaser of a negotiable instrument would **least** likely be a holder in due course if, at the time of purchase, the instrument is

- a. Purchased at a discount.
- b. Collateral for a loan.
- c. Payable to bearer on demand.
- d. Overdue by three weeks.

N88#41. Able drew a check payable to the order of Baker. The amount was left blank because it depended on a future delivery of fuel oil to Able, and the exact price was not known at the time the check was issued. Baker estimated the amount at \$400, but told Able that in no event would it be more than \$600. Baker failed to deliver the fuel oil, but filled in the amount of the check for \$800. Baker then negotiated the check to Cook in satisfaction of a \$600 debt, with the \$200 balance paid to Baker in cash. Able stopped payment and Cook is seeking to collect \$800 from Able. Able's maximum liability to Cook will be

- a. \$0
- b. \$400
- c. \$600
- d. \$800

Business Law

M88#46. Ard is holding the following instrument:

I, Rosemary Larkin, hereby promise to pay to the bearer twenty thousand dollars (\$20,000). This document is given by me as payment of the balance due on my purchase of a 1984 Winnebago mobile home from Ed Dill and is payable when I am able to obtain a bank loan.

Rosemary Larkin
Rosemary Larkin

October 30, 1987

To: Bill Blake
P.O. Box 37
Dubuque, Iowa

Pay to the order of Gary Gold
Five Thousand and no/100 Dollars

Mary Kurke
Mary Kurke

This instrument is **not** negotiable because it

- a. Refers to the contract out of which it arose.
- b. Is payable to bearer rather than to a named payee.
- c. Is **not** dated on the face of the instrument.
- d. Is **not** payable at a definite time.

Which of the following is correct?

- a. As the drawer, Blake is primarily liable on the instrument.
- b. The instrument is a negotiable note.
- c. The instrument is payable on demand.
- d. As the drawee, Blake is secondarily liable on the instrument.

M88#47. Assuming each of the following is negotiable, which qualifies as a draft under the UCC Commercial Paper Article?

- a. A warehouse receipt.
- b. A demand promissory note.
- c. A document of title.
- d. A trade acceptance.

N87#47. In order to negotiate bearer paper, one must

- a. Endorse the paper.
- b. Endorse and deliver the paper with consideration.
- c. Deliver the paper.
- d. Deliver and endorse the paper.

M88#48. The value requirement in determining whether a person is a holder in due course with respect to a check will **not** be satisfied by the taking of the check

- a. As security for an obligation to the extent of the obligation.
- b. As payment for an antecedent debt.
- c. In exchange for another negotiable instrument.
- d. In exchange for a promise to perform services in the future.

N87#48. A company has in its possession the following instrument:

\$500.00 Dayton, Ohio October 2, 1987

Sixty days after date I promise to pay to the order of

at Cash
 Five hundred Dollars
 Miami, Florida

Value received with interest at the rate of nine percent per annum.

This instrument is secured by a conditional sales contract.

No. 11 Due December 1, 1987 *Craig Burke*
 Craig Burke

N87#45. Which of the following negotiable instruments is subject to the provisions of the UCC Article on Commercial Paper?

- a. Bearer bond containing a maturity date of December 1, 1987.
- b. Bill of lading payable to order.
- c. Installment note payable on the first day of each month.
- d. Warehouse receipt.

N87#46. The following instrument has been received by Gary Gold:

This instrument is

- a. Not negotiable until December 1, 1987.
- b. A negotiable bearer note.
- c. A negotiable time draft.
- d. A non-negotiable note since it states that it is secured by a conditional sales contract.

Selected Questions

N87#49. One of the requirements necessary to qualify as a holder of a negotiable bearer check is that the transferee must

- a. Take the check in good faith.
- b. Give value for the check.
- c. Have possession of the check.
- d. Receive the check that was originally made payable to bearer.

N87#50. A holder in due course of a negotiable promissory note will take the note subject to which of the following defenses?

- a. Fraud in the inducement.
- b. Failure of consideration.
- c. Unauthorized signature.
- d. Breach of contract.

N87#46. Which of the following on the face of an otherwise negotiable instrument will affect the instrument's negotiability?

- a. The instrument is postdated.
- b. The instrument is payable six months after the death of the maker.
- c. The instrument contains a promise to provide additional collateral if there is a decrease in value of the existing collateral.
- d. The instrument is payable at a definite time subject to an acceleration clause in the event of a default.

N86#40. Dart induces Shorr by fraud to make a promissory note payable to Dart. Dart negotiates the note for value to Best, who was aware of the fraud. Best negotiates the note to Case, a holder in due course. Subsequently, Best repurchases the note from Case. Which of the following statements is correct?

- a. Best does **not** succeed to Case's rights as a holder in due course.
- b. Best becomes a holder in due course upon taking the note from Dart.
- c. Because of the fraud by Dart, the note is non-negotiable.
- d. Best's knowledge of Dart's fraud is immaterial in determining Best's status as a holder in due course.

N86#41. Hand executed and delivered to Rex a \$1,000 negotiable note payable to Rex or bearer. Rex then negotiated it to Ford and endorsed it on the back by merely signing his name. Which of the following is a correct statement?

- a. Rex's endorsement was a special endorsement.

- b. Rex's endorsement was necessary to Ford's qualification as a holder.
- c. The instrument initially being bearer paper can **not** be converted to order paper.
- d. The instrument is bearer paper and Ford can convert it to order paper by writing "pay to the order of Ford" above Rex's signature.

N86#43. Which of the following prevents an instrument from being negotiable?

- a. An endorsement on the back of the instrument which reads: "Pay Smith only."
- b. An instrument which is payable after completion of a contractual obligation which is certain to happen but uncertain as to the time of occurrence.
- c. The fact that it is unclear whether the instrument is intended to be a note or a draft.
- d. The capacity in which the party signed was unclear.

N86#44. Your client has in its possession the following instrument:

No. <u>1625</u>
FAIR FOOD WHOLESALERS, INC. 22 Woodrow Wilson Hayes Lane Columbus, Ohio
<u>Jan. 10, 1986</u>
On demand the undersigned promises to pay to
<u>Bearer</u> <u>\$1,200.00</u>
<u>Twelve hundred & ten/100's</u> <u>Dollars</u>
Fair Food Wholesalers, Inc.
By <u>James Duff</u>
James Duff, President
For: _____

The instrument is

- a. A non-negotiable promissory note.
- b. Non-negotiable because the instrument is incomplete.
- c. A negotiable time draft.
- d. Negotiable despite the inconsistency between the amount in words and the amount in numbers.

Business Law

M86#26. An instrument reads as follows:

Pay to the	April 1, 1986
Order of <u>Donald Kent, Fifteen days after date</u> , \$100.00	
<u>One hundred and no/100</u>	Dollars
Union Corp. Ridgefield, Connecticut	
<u>Dale Cox</u>	
re: down payment on auto purchase	

The instrument

- Is non-negotiable since it incorporates the auto purchase transaction by reference.
- Is a negotiable time draft.
- Is a negotiable sight draft.
- Is a non-negotiable trade acceptance.

M86#28. Frank Supply Co. held the following instrument:

Clark Novelties, Inc. 29 State Street Spokane, Washington	April 12, 1986
Pay to the order of Frank Supply Co. on April 30, 1986 ten thousand and 00/100 dollars (\$10,000.00).	
Smith Industries, Inc. <u>J. C. Kahn</u> J.C. Kahn, President	
ACCEPTED: Clark Novelties, Inc. BY: <u>Mitchell Clark</u> Mitchell Clark, President	
Date: April 20, 1986	

As a result of an audit examination of this instrument which was properly endorsed by Frank to your client, it may be correctly concluded that

- Smith was primarily liable on the instrument prior to acceptance.
- The instrument is non-negotiable and thus no one has rights under the instrument.
- No one was primarily liable on the instrument at the time of issue, April 12, 1986.
- Upon acceptance, Clark Novelties, Inc. became primarily liable and Smith was released from all liability.

M86#29. The UCC Article on Commercial Paper requires that an instrument, to be negotiable, must "contain an unconditional promise or order to pay. . . ." The requirement is met by which of the following?

- "I hereby acknowledge my debt to the payee."
- "I hereby assign all my rights to collect all monies due on the instrument."
- "Pay to bearer" contained in a draft.
- An endorsement which reads "pay to the order of. . . ."

M86#30. Karr transferred a negotiable instrument payable to his order to Watson for value. Karr did not endorse the instrument. As a result of the transfer, Watson

- Obtains such rights as the transferor had in all cases.
- Can become a holder only if the instrument is endorsed and delivered at the same time.
- Is presumed to be the owner of the instrument since he gave value.
- Is entitled to an unqualified endorsement by Karr.

M86#31. The status of a holder in due course as opposed to a mere holder of a negotiable instrument

- Is of little consequence as a practical matter.
- Eliminates the necessity of making due presentment or giving notice of dishonor.
- Allows the holder in due course to overcome certain defenses that can **not** be overcome by a mere holder.
- Allows the further negotiation of the instrument.

N85#36. An instrument complies with the requirements for negotiability contained in the UCC Article on Commercial Paper. The instrument contains language expressly acknowledging the receipt of \$40,000 by Mint Bank and an agreement to repay principal with interest at 11% six months from date. The instrument is

- A banker's acceptance.
- A banker's draft.
- A negotiable certificate of deposit.
- Nonnegotiable because of the additional language.

N85#37. Jane Lane, a sole proprietor, has in her possession several checks which she received from her customers. Lane is concerned about the safety of the checks since she believes that many of them are bearer paper which may be cashed without endorsement. The checks in Lane's possession will be considered order paper rather than bearer paper if they were made payable (in the drawer's handwriting) to the order of

- Cash.
- Ted Tint, and endorsed by Ted Tint in blank.
- Bearer, and endorsed by Ken Kent making them payable to Jane Lane.
- Bearer, and endorsed by Sam Sole in blank.

Selected Questions

N85#38. The requirements for an instrument to qualify as negotiable commercial paper

- a. May be waived by a separate agreement signed by the original parties to the instrument as long as the variations are fair and voluntarily agreed upon.
- b. Prohibit substitutions or variances from the exact language of the UCC.
- c. May be satisfied by the insertion of a clause in the instrument indicating that the instrument is negotiable.
- d. Must be satisfied at least in principle, although the exact language set forth in the UCC may be varied.

N85#39. John Daly received a check which was originally made payable to the order of one of his customers, Al Pine. The following endorsement was written on the back of the check:

Al Pine, without recourse, for collection only

The endorsement on this check would be classified as

- a. Blank, unqualified, and non-restrictive.
- b. Blank, qualified, and restrictive.
- c. Special, unqualified, and restrictive.
- d. Special, qualified, and non-restrictive.

N85#40. Below is a note which your client Best Realtors obtained from Green in connection with Green's purchase of land located in Rye, N.Y. The note was given for the balance due on the purchase and was secured by a first mortgage on the land.

\$90,000.00

Rye, N.Y.
May 1, 1985

For value received, six years after date, I promise to pay to the order of Best Realtors NINETY THOUSAND and 00/100 DOLLARS with interest at 16% compounded annually until fully paid. This instrument arises out of the sale of land located in N.Y. and the law of N.Y. is to be applied to any question which may arise. It is secured by a first mortgage on the land conveyed. It is further agreed that:

1. Purchaser will pay the costs of collection including attorney's fees upon default.
2. Purchaser may repay the amount outstanding on any anniversary date of this note.

Ted Green

Ted Green

This note is a

- a. Negotiable promissory note.
- b. Negotiable investment security under the UCC.
- c. Nonnegotiable promissory note since it is secured by a first mortgage.
- d. Nonnegotiable promissory note since it permits prepayment and requires the maker's payment of the costs of collection and attorney's fees.

N85#41. Hunt has in his possession a negotiable instrument which was originally payable to the order of Carr. It was transferred to Hunt by a mere delivery by Drake, who took it from Carr in good faith in satisfaction of an antecedent debt. The back of the instrument read as follows, "Pay to the order of Drake in satisfaction of my prior purchase of a new video calculator, signed Carr." Which of the following is correct?

- a. Hunt has the right to assert Drake's rights, including his standing as a holder in due course and also has the right to obtain Drake's signature.
- b. Drake's taking the instrument for an antecedent debt prevents him from qualifying as a holder in due course.
- c. Carr's endorsement was a special endorsement; thus Drake's signature was **not** required in order to negotiate it.
- d. Hunt is a holder in due course.

N85#42. Frey paid Holt \$2,500 by check pursuant to an agreement between them whereby Holt promised to perform in Frey's theater within the next year. Holt endorsed the check, making it payable to Len Able. Holt's status with regard to the check was one of a(an)

- a. Assignee since a payee may **not** also be a holder in due course.
- b. Holder since Holt's promise failed to satisfy the value requirement necessary to become a holder in due course.
- c. Holder in due course under the shelter rule since Able's rights as a holder in due course revert to Holt.
- d. Holder in due course since all the requirements have been satisfied.

N85#43. Blue is a holder of a check which was originally drawn by Rush and made payable to Silk. Silk properly endorsed the check to Field. Field had the check certified by the drawee bank and then endorsed the check to Blue. As a result

- a. Field is discharged from liability.
- b. Rush alone is discharged from liability.
- c. The drawee bank becomes primarily liable and both Silk and Rush are discharged.
- d. Rush is secondarily liable.

Business Law

M85#33. The following instrument was received by Kerr:

Madison, Wisconsin	April 5, 1985
Sixty days after date pay to the order of Donald Kerr, one hundred and fifty dollars (\$150). Value received and charge the trade account of Olympia Sales Corp., N.Y.	
To: New City Bank, U.N. Plaza, New York, N.Y.	Olympia Sales Corp. by <u>Carl Starr</u> President

The instrument is a

- Negotiable time draft.
- Check.
- Promissory note.
- Trade acceptance.

M85#34. Jason contracted to sell his business to Farr. Upon execution of the contract by Farr, he delivered a note in lieu of earnest money which recited the nature of the transaction and indicated that it was payable on the date of the closing which was to be determined by the mutual consent of the parties. The note is

- Non-negotiable because no consideration is given.
- Non-negotiable because of the recitation of the transaction which gave rise to it.
- Non-negotiable since it is **not** payable at a definite time.
- Negotiable.

M85#35. A holder in due course will take free of which of the following defenses?

- A wrongful filling-in of the amount payable which was omitted from the instrument.
- Duress of a nature which renders the obligation of the party a nullity.
- Infancy to the extent that it is a defense to a simple contract.
- Discharge of the maker in bankruptcy.

M85#36. Your client, MDS Discount Services, Inc., purchased the following instrument from John Cross on February 15, 1985. Cross had received it in connection with the sale to Dann Corp. of real property he owned located in Utah. Cross endorsed it in blank and received \$24,000 from MDS.

\$26,000.00

Boston, Massachusetts
February 2, 1985

Sixty days after date, I promise to pay to the order of John Cross Twenty Six Thousand & 00/100 Dollars at the Second National Bank of Provo, Utah.

Value received with interest at the rate of 14% per annum. This instrument arises out of the sale of real estate located in the state of Utah. It is further agreed that this instrument is:

- Subject to all implied and constructive conditions.
- Secured by a first mortgage given as per the sale of the real estate mentioned above.
- To be paid out of funds deposited in the City Bank of Wabash, Illinois.

Dann Corp.

by Joan Dann
President

The instrument is

- Non-negotiable due to the language contained in clause number 1.
- Non-negotiable since it incorporates by reference the terms of the mortgage indicated in clause number 2.
- Negotiable since it contains the words "value received" and specifies the required recitation of the transaction out of which it arose.
- Negotiable despite the language contained in clauses numbered 1, 2, and 3.

M85#37. Bond fraudulently induced Kent to make a note payable to Baker to whom Bond was indebted. Bond delivered the note to Baker. Baker negotiated the instrument to Monk who purchased it with knowledge of the fraud and after it was overdue. If Baker qualifies as a holder in due course, which of the following is correct?

- Monk can personally qualify as a holder in due course.
- Monk has the standing of a holder in due course through Baker.
- Monk can **not** collect because he purchased with knowledge of the fraud and after it was overdue.
- Kent can successfully assert the defense of fraud against Monk.

M85#38. In connection with a check and a promissory note, which of the following is correct?

- A promissory note may only be made payable to the order of a named payee.

Selected Questions

- b. A promissory note may only be payable at a stated time in order to meet the requirements for negotiability.
- c. A check may be made payable upon the happening of an event uncertain as to the time of occurrence without affecting its negotiability.
- d. A check may be made payable to the order of the drawer or to bearer.

M85#39. A person who endorsed a check "without recourse"

- a. Has the same liability as an accommodation endorser.
- b. Only negates his liability insofar as prior parties are concerned.
- c. Gives the same warranty protection to his transferee as does a special or blank endorser.
- d. Does **not** promise or guarantee payment of the instrument upon dishonor even if there has been a proper presentment and proper notice has been given.

B. Documents of Title and Investment Securities

M89#53. Under the UCC, a warehouse receipt

- a. Will **not** be negotiable if it contains a contractual limitation on the warehouseman's liability.
- b. May qualify as both a negotiable warehouse receipt and negotiable commercial paper if the instrument is payable either in cash or by the delivery of goods.
- c. May be issued only by a bonded and licensed warehouseman.
- d. Is negotiable if by its terms the goods are to be delivered to bearer or the order of a named person.

N88#42. Which of the following is **not** a warranty made by the seller of a negotiable warehouse receipt to the purchaser of the document?

- a. The document transfer is fully effective with respect to the goods it represents.
- b. The warehouseman will honor the document.
- c. The seller has **no** knowledge of any facts that would impair the document's validity.
- d. The document is genuine.

M88#49. The procedure necessary to negotiate a document of title depends principally on whether the document is

- a. An order document or a bearer document.
- b. Issued by a bailee or a consignee.
- c. A receipt for goods stored or goods already shipped.
- d. A bill of lading or a warehouse receipt.

N87#36. Bond Corp. issued a negotiable warehouse receipt to Grey for goods stored in Bond's warehouse. Grey's goods were lost due to Bond's failure to exercise such care as a reasonably careful person would under like circumstances. The state in which this transaction occurred follows the UCC rule with respect to a warehouseman's liability for lost goods. The warehouse receipt is silent on this point. Under the circumstances, Bond is

- a. Liable because it was negligent.
- b. Liable because it is strictly liable for any loss.
- c. Not liable unless Grey can establish that Bond was grossly negligent.
- d. Not liable because the warehouse receipt was negotiable.

M87#47. Assuming all other requirements have been met, which of the following terms generally must be included in a writing in order to satisfy the UCC statute of frauds regarding the sale of securities?

	<u>Price</u>	<u>Quantity</u>	<u>Time of payment</u>
a.	Yes	Yes	Yes
b.	No	Yes	No
c.	Yes	No	Yes
d.	Yes	Yes	No

N86#48. Klep burglarized the premises of Apple Sales Co. He stole several negotiable warehouse receipts which were deliverable to the order of Apple. Klep indorsed Apple's name on the instruments and transferred them to Margo Wholesalers, a bona fide purchaser for value. As between Apple and Margo,

- a. Apple will prevail since the warehouseman must be notified before any negotiation is effective.
- b. Apple will prevail since the thief's indorsement prevents a due negotiation.
- c. Margo will prevail since it has taken a negotiable warehouse receipt as a bona fide purchaser for value.
- d. Margo will prevail since the warehouse receipt was converted to a bearer instrument by Klep's indorsement.

N85#45. Bell Co. owned 20 engines which it deposited in a public warehouse on May 5, receiving a negotiable warehouse receipt in its name. Bell sold the engines to Spark Corp. On which of the following dates did the risk of loss transfer from Bell to Spark?

- a. June 11 — Spark signed a contract to buy the engines from Bell for \$19,000. Delivery was to be at the warehouse.
- b. June 12 — Spark paid for the engines.
- c. June 13 — Bell negotiated the warehouse receipt to Spark.
- d. June 14 — Spark received delivery of the engines at the warehouse.

Business Law

M85#40. Unless otherwise agreed, which of the following warranties will **not** be conferred by a person negotiating a negotiable warehouse receipt for value to his immediate purchaser?

- a. The document is genuine.
- b. The transferor is without knowledge of any fact which would impair its validity or worth.
- c. The goods represented by the warehouse receipt are of merchantable quality.
- d. Negotiation by the transferor is rightful and fully effective with respect to the title to the document.

C. Sales

M89#54. With regard to a contract governed by the UCC Sales Article, which one of the following statements is correct?

- a. Merchants and non-merchants are treated alike.
- b. The contract may involve the sale of any type of personal property.
- c. The obligations of the parties to the contract must be performed in good faith.
- d. The contract must involve the sale of goods for a price of more than \$500.

M89

Items 55 through 58 are based on the following:

Lazur Corp. entered into a contract with Baker Suppliers, Inc. to purchase a used word processor from Baker. Lazur is engaged in the business of selling new and used word processors to the general public. The contract required Baker to ship the goods to Lazur by common carrier pursuant to the following provision in the contract: "F.O.B. — Baker Suppliers, Inc. loading dock." Baker also represented in the contract that the word processor had been used for only 10 hours by its previous owner. The contract included the provision that the word processor was being sold "as is" and this provision was in a larger and different type style than the remainder of the contract.

55. With regard to the contract between Lazur and Baker,

- a. An implied warranty of merchantability does **not** arise unless both Lazur and Baker are merchants.
- b. The "as is" provision effectively disclaims the implied warranty of title.
- c. No express warranties are created by the contract.
- d. The "as is" provision would **not** prevent Baker from being liable for a breach of any express warranties created by the contract.

56. *For this item only*, assume that during shipment to Lazur the word processor was seriously damaged when the carrier's truck was involved in an accident.

When the carrier attempted to deliver the word processor, Lazur rejected it and has refused to pay Baker the purchase price. Under the UCC Sales Article,

- a. Lazur rightfully rejected the damaged computer.
- b. The risk of loss for the computer was on Lazur during shipment.
- c. At the time of the accident, risk of loss for the computer was on Baker because title to the computer had **not** yet passed to Lazur.
- d. Lazur will **not** be liable to Baker for the purchase price of the computer because of the F.O.B. provision in the contract.

57. *For this item only*, assume that the contract between Lazur and Baker is otherwise silent. Under the UCC Sales Article,

- a. Lazur must pay Baker the purchase price before Baker is required to ship the word processor to Lazur.
- b. Baker does **not** warrant that it owns the word processor.
- c. Lazur will be entitled to inspect the word processor before it accepts or pays for it.
- d. Title to the word processor passes to Lazur when it takes physical possession.

58. *For this item only*, assume that Lazur refused to accept the word processor even though it was in all respects conforming to the contract and that the contract is otherwise silent. Under the UCC Sales Article,

- a. Baker can successfully sue for specific performance and make Lazur accept and pay for the word processor.
- b. Baker may resell the word processor to another buyer.
- c. Baker must sue for the difference between the market value of the word processor and the contract price plus its incidental damages.
- d. Baker cannot successfully sue for consequential damages unless it attempts to resell the word processor.

N88#43. In general, the UCC Sales Article applies to the sale of

- a. Goods only if the seller is a merchant and the buyer is **not**.
- b. Goods only if the seller and buyer are both merchants.
- c. Consumer goods by a non-merchant.
- d. Real estate by a merchant for \$500 or more.

N88#44. Under the UCC Sales Article, a firm offer will be created only if the

- a. Offeree is a merchant.
- b. Offeree gives some form of consideration.
- c. Offer states the time period during which it will remain open.
- d. Offer is made by a merchant in a signed writing.

Selected Questions

N88#45. Which of the following factors will be most important in determining whether an express warranty has been created concerning goods sold?

- a. The seller gave a description of the goods that is part of the basis of the bargain.
- b. The buyer or seller is a merchant with respect to the goods being sold.
- c. Whether the seller intended to create the express warranty.
- d. Whether the buyer relied on the seller's statements.

N88#46. If goods have been delivered to a buyer pursuant to a sale or return contract, the

- a. Buyer may use the goods but **not** resell them.
- b. Seller is liable for the expenses incurred by the buyer in returning the goods to the seller.
- c. Title to the goods remains with the seller.
- d. Risk of loss for the goods passed to the buyer.

N88#47. Which of the following is necessary in order for the warranty of merchantability to arise where there has been a sale of goods?

- I. The seller must be a merchant with respect to goods of that kind.
 - II. The warranty must be in writing.
 - III. The buyer must have relied on the seller's skill or judgment in selecting the goods.
- a. I and III only.
 - b. I, II, and III.
 - c. II and III only.
 - d. I only.

N88#48. Cain and Zen Corp. orally agreed that Zen would specially manufacture a machine for Cain at a price of \$40,000. After Zen completed the work at a cost of \$30,000, Cain notified Zen that it no longer needed the machine. Zen is holding the machine for Cain and has requested payment from Cain. Despite making reasonable efforts, Zen has been unable to resell the machine for any price. Zen has incurred warehouse fees of \$500 for storing the machine. If Cain refuses to pay Zen and Zen sues Cain, the most Zen will be entitled to recover is

- a. \$0
- b. \$30,500
- c. \$40,000
- d. \$40,500

N88#49. Sutter purchased a computer from Harp. Harp is not in the business of selling computers. Harp tendered delivery of the computer after receiving payment in full from Sutter. Sutter informed Harp that Sutter was unable to take possession of the computer at that time, but would return later that day. Before Sutter returned, the computer was destroyed by a fire. The risk of loss

- a. Remained with Harp, since title had **not** yet passed to Sutter.

- b. Passed to Sutter upon Harp's tender of delivery.
- c. Remained with Harp, since Sutter had **not** yet received the computer.
- d. Passed to Sutter at the time the contract was formed and payment was made.

N88#50. Bean ordered 40 beige refrigerators at list price from Tish Co. Immediately upon receipt of Bean's order, Tish sent Bean an acceptance which was received by Bean. The acceptance indicated that shipment would be made within ten days. On the tenth day Tish discovered that all of its supply of beige refrigerators had been sold. Instead it shipped 40 white refrigerators, stating clearly on the invoice that the shipment was sent only as an accommodation. Which of the following is correct?

- a. Bean's order is a unilateral offer, and can only be accepted by Tish's shipment of the goods ordered.
- b. Tish's shipment of white refrigerators is a counteroffer, thus **no** contract exists between Bean and Tish.
- c. Tish's note of accommodation cancels the contract between Tish and Bean.
- d. Tish's shipment of white refrigerators constitutes a breach of contract.

N88#51. On March 7, 1988, Wax Corp. contracted with Noll Wholesalers to supply Noll with specific electrical parts. Delivery was called for on June 3, 1988. On May 2, 1988, Wax notified Noll that it would not perform and that Noll should look elsewhere. Wax had received a larger and more lucrative contract on April 21, 1988, and its capacity was such that it could not fulfill both orders. The facts

- a. Will prevent Wax from retracting its repudiation of the Noll contract.
- b. Are **not** sufficient to clearly establish an anticipatory repudiation.
- c. Will permit Noll to sue only after June 3, 1988, the latest performance date.
- d. Will permit Noll to sue immediately after May 2, 1988, even though the performance called for under the contract was **not** due until June 3, 1988.

M88#50. Under the UCC Sales Article, which of the following warranties requires the seller to be a merchant with respect to the goods being sold in order for the warranty to apply?

	<i>Implied warranty of fitness for a particular purpose</i>	<i>Implied warranty of merchantability</i>
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

Business Law

N87#37. With respect to the sale of goods, the warranty of title

- a. Provides that the seller deliver the goods free from any lien of which the buyer lacked knowledge at the time of contracting.
- b. Provides that the seller can **not** disclaim the warranty if the sale is made to a bona fide purchaser for value.
- c. Applies only if the seller is a merchant.
- d. Applies only if it is in writing and signed by the seller.

N87#38. In order to establish a cause of action based upon strict liability in tort for personal injuries resulting from the use of a defective product, one of the elements the plaintiff must prove is that the seller (defendant)

- a. Was engaged in the business of selling the product.
- b. Failed to exercise due care.
- c. Defectively designed the product.
- d. Was in privity of contract with the plaintiff.

N87#39. Sand Corp. sold and delivered a photocopier to Barr for use in Barr's business. According to their agreement, Barr may return the copier within 30 days. During the 30-day period, if Barr has **not** returned the copier or indicated acceptance of it, which of the following statements is correct with respect to risk of loss and title?

- a. Risk of loss and title passed to Barr.
- b. Risk of loss and title remain with Sand.
- c. Risk of loss passed to Barr but title remains with Sand.
- d. Risk of loss remains with Sand but title passed to Barr.

N87#40. An oral agreement concerning the sale of goods entered into without consideration is binding if the agreement

- a. Is a firm offer made by a merchant who promises to hold the offer open for 30 days.
- b. Is a waiver of the non-breaching party's rights arising out of a breach of the contract.
- c. Contradicts the terms of a subsequent written contract that is intended as the complete and exclusive agreement of the parties.
- d. Modifies the price in an existing, enforceable contract from \$525 to \$475.

M87#48. Under the UCC Sales Article, the warranty of title may be excluded

- a. By the seller's statement that she is selling only such right or title that she has.
- b. By the seller's statement that the goods are being sold with all faults.
- c. Only in a writing signed by the seller.
- d. Only by a non-merchant seller.

M87#49. Which of the following factors will be most important in determining if an express warranty has been created?

- a. Whether the statements made by the seller were in writing.
- b. Whether the seller intended to create a warranty.
- c. Whether the promises made by the seller became part of the basis of the bargain.
- d. Whether the sale was made by a merchant in the regular course of business.

M87#50. Under the UCC, an action for breach of the implied warranty of merchantability by a party who sustained personal injuries may be successful against the seller of the product only when

- a. The injured party is in privity of contract with the seller.
- b. The seller is a merchant with respect to the product involved.
- c. An action based on strict liability in tort can also be successfully maintained.
- d. An action based on negligence can also be successfully maintained.

M87

Items 52 and 53 are based on the following information:

On April 5, 1987, Anker, Inc., furnished Bold Corp. with Anker's financial statements dated March 31, 1987. The financial statements contained misrepresentations which indicated that Anker was solvent when in fact it was insolvent. Based on Anker's financial statements, Bold agreed to sell Anker 90 computers, "F.O.B. — Bold's loading dock." On April 14, Anker received 60 of the computers. The remaining 30 computers are in the possession of the common carrier and in transit to Anker.

52. If on April 28, Bold discovered that Anker was insolvent, then with respect to the computers delivered to Anker on April 14, Bold may

- a. Reclaim the computers upon making a demand.
- b. Reclaim the computers irrespective of the rights of any subsequent third party.
- c. Not reclaim the computers since ten days have elapsed from its delivery.
- d. Not reclaim the computers since it is entitled to recover the price of the computers.

53. With respect to the remaining 30 computers in transit, which of the following statements is correct if Anker refuses to pay Bold in cash and Anker is **not** in possession of a negotiable document of title covering the computers?

- a. Bold may stop delivery of the computers to Anker since their contract is void due to Anker's furnishing of the false financial statements.

Selected Questions

- b. Bold may stop delivery of the computers to Anker despite the fact that title had passed to Anker.
- c. Bold must deliver the computers to Anker on credit since Anker has **not** breached the contract.
- d. Bold must deliver the computers to Anker since the risk of loss had passed to Anker.

M87#54. If a contract for the sale of goods includes a C. & F. shipping term and the seller has fulfilled all of its obligations, the

- a. Title to the goods will pass to the buyer when the goods are received by the buyer at the place of destination.
- b. Risk of loss will pass to the buyer upon delivery of the goods to the carrier.
- c. Buyer retains the right to inspect the goods prior to making payment.
- d. Seller must obtain an insurance policy at its own expense for the buyer's benefit.

M87#55. Which of the following is most important in determining who bears the risk of loss in a sale of goods contract?

- a. The shipping terms.
- b. The agreement of the parties.
- c. Who has title to the goods.
- d. Who has possession of the goods.

N86#46. Kent suffered an injury due to a malfunction of a chain saw he had purchased from Grey Hardware. The saw was manufactured by Dill Tool Corp. Kent has commenced an action against Grey and Dill based upon strict liability. Which of the following is a correct statement?

- a. Dill will **not** be liable if it manufactured the saw in a nonnegligent manner.
- b. Privity will **not** be a valid defense against Kent's suit.
- c. The lawsuit will be dismissed since strict liability has **not** been applied in product liability cases in the majority of jurisdictions.
- d. Kent's suit against Grey will be dismissed since Grey was **not** at fault.

N86#47. Greed Co. telephoned Stieb Co. and ordered 30 tables at \$100 each. Greed agreed to pay 15% immediately and the balance within thirty days after receipt of the entire shipment. Greed forwarded a check for \$450 and Stieb shipped 15 tables the next day, intending to ship the balance by the end of the week. Greed decided that the contract was a bad bargain and repudiated it, asserting the statute of frauds. Stieb sued

Greed. Which of the following will allow Stieb to enforce the contract in its entirety despite the statute of frauds?

- a. Stieb shipped 15 tables.
- b. Greed paid 15% down.
- c. The contract is **not** within the requirements of the statute of frauds.
- d. Greed admitted in court that it made the contract in question.

M86#33. Tint is suing the manufacturer, the wholesaler, and the retailer for bodily injuries caused by a snowblower Tint purchased. Under the theory of strict liability

- a. Contributory negligence on Tint's part will always be a bar to recovery.
- b. Privity will be a bar insofar as the wholesaler is concerned if the wholesaler did **not** have a reasonable opportunity to inspect.
- c. Tint may recover despite the fact that he can **not** show that any negligence was involved.
- d. The manufacturer will avoid liability if it can show it followed the custom of the industry.

M86#34. The UCC Sales Article applies

- a. To a contract for personal services.
- b. To the sale of patents.
- c. To the sale of goods only if the buyer and seller are merchants.
- d. To the sale of specially manufactured goods.

N85#46. Which of the following terms generally must be included in a writing which would otherwise satisfy the UCC statute of frauds regarding the sale of goods?

- a. The warranties to be granted.
- b. The price of the goods.
- c. The designation of the parties as buyer and seller.
- d. The quantity of the goods.

N85#47. Dill purchased a computer from Park, who regularly sells computers to the general public. After receiving payment in full, Park tendered delivery of the computer to Dill. Rather than take immediate delivery, Dill stated that he would return later that day to pick up the computer. Before Dill returned, thieves entered Park's store and stole Dill's computer. The risk of loss

- a. Remained with Park since title had **not** yet passed to Dill.
- b. Remained with Park since Dill had **not** yet received the computer.
- c. Passed to Dill upon Park's tender of delivery.
- d. Passed to Dill at the time the contract was formed and payment was made.

N85#48. Kirk Corp. sold Nix an Ajax freezer, Model 24, for \$490. The contract required delivery to be made by June 23. On June 12, Kirk delivered an Ajax freezer, Model 52, to Nix. Nix immediately notified Kirk that the wrong freezer had been delivered and indicated that the delivery of a correct freezer would not be acceptable. Kirk wishes to deliver an Ajax freezer, Model 24 on June 23. Which of the following statements is correct?

- a. Kirk may deliver the freezer on June 23 without further notice to Nix.
- b. Kirk may deliver the freezer on June 23 if it first seasonably notifies Nix of its intent to do so.
- c. Nix must accept the non-conforming freezer but may recover damages.
- d. Nix always may reject the non-conforming freezer and refuse delivery of a conforming freezer on June 23.

M85#42. The Uniform Commercial Code's position on privity of warranty as to personal injuries

- a. Allows the buyer's family the right to sue only the party from whom the buyer purchased the product.
- b. Resulted in a single uniform rule being adopted throughout most of the United States.
- c. Prohibits the exclusion on privity grounds of third parties from the warranty protection it has granted.
- d. Applies exclusively to manufacturers.

M85#43. Flax telephoned Sky Corp. and ordered a specially manufactured air conditioner for \$1,900. Subsequently, Flax realized that he miscalculated the area which was to be cooled and concluded that the air conditioner would not be acceptable. Sky had already completed work on the air conditioner, demanded payment, and was unable to resell the unit at a reasonable price. If Flax refuses to pay and Sky brings an action seeking as damages the price plus reasonable storage charges of \$50, Sky will recover

- a. Nothing, because of the statute of frauds.
- b. Only its lost profit.
- c. The full \$1,950.
- d. Only \$1,900.

D. Secured Transactions

M89#47. Acorn Marina, Inc. sells and services boat motors. On April 1, 1989, Acorn financed the purchase of its entire inventory with GAC Finance Company. GAC required Acorn to execute a security agreement and financing statement covering the inventory and proceeds of sale. On April 14, 1989, GAC properly filed the financing statement pursuant to the UCC Secured Transactions Article. On April 27, 1989, Acorn sold one of the motors to Wilks for use in his charter busi-

ness. Wilks, who had once worked for Acorn, knew that Acorn regularly financed its inventory with GAC. Acorn has defaulted on its obligations to GAC. The motor purchased by Wilks is

- a. Subject to the GAC security interest because Wilks should have known that GAC financed the inventory purchase by Acorn.
- b. Subject to the GAC security interest because Wilks purchased the motor for a commercial use.
- c. Not subject to the GAC security interest because Wilks is regarded as a buyer in the ordinary course of Acorn's business.
- d. Not subject to the GAC security interest because GAC failed to file the financing statement until more than 10 days after April 1, 1989.

M89#60. Burn Manufacturing borrowed \$500,000 from Howard Finance Co., secured by Burn's present and future inventory, accounts receivable, and the proceeds thereof. The parties signed a financing statement that described the collateral and it was filed in the appropriate state office. Burn subsequently defaulted in the repayment of the loan and Howard attempted to enforce its security interest. Burn contended that Howard's security interest was unenforceable. In addition, Green, who subsequently gave credit to Burn without knowledge of Howard's security interest, is also attempting to defeat Howard's alleged security interest. The security interest in question is valid with respect to

- a. Both Burn and Green.
- b. Neither Burn nor Green.
- c. Burn but not Green.
- d. Green but not Burn.

N88#52. Mern Corp. is in the business of selling computers and computer software to the public. Mern sold and delivered a personal computer to Whyte on credit. Whyte executed and delivered to Mern a promissory note for the purchase price and a security agreement covering the computer. If Whyte purchased the computer for personal use and Mern fails to file a financing statement, which of the following statements is correct?

- a. The computer was a consumer good while in Mern's possession.
- b. Perfection of Mern's security interest occurred at the time of attachment.
- c. Mern's security interest is not enforceable against Whyte because Mern failed to file a financing statement.
- d. Mern does not have a perfected security interest because it failed to file a financing statement.

N88#53. Dart Co., which is engaged in the business of selling appliances, borrowed \$8,000 from Arco Bank. Dart executed a promissory note for that amount and pledged all of its customer installment receivables

Selected Questions

as collateral for the loan. Dart executed a security agreement which described the collateral, but Arco did not file a financing statement. With respect to this transaction

- a. Attachment of the security interest took place when Dart executed the security agreement.
- b. Attachment of the security interest did **not** occur because Arco failed to file a financing statement.
- c. Perfection of the security interest occurred despite Arco's failure to file a financing statement.
- d. The UCC Secured Transactions Article does **not** apply because Arco failed to file a financing statement.

N88#54. With regard to a prior perfected security interest in goods for which a financing statement has been filed, which of the following parties is most likely to have a superior interest in the same collateral?

- a. A buyer in the ordinary course of business who purchased the goods from a merchant.
- b. A subsequent buyer of consumer goods who purchased the goods from another consumer.
- c. The trustee in bankruptcy of the debtor.
- d. Lien creditors of the debtor.

N88#55. Bonn, a secured party, sells collateral at a private sale to a good faith purchaser for value after the debtor defaults. Which of the following statements is correct under the UCC Secured Transactions Article?

- a. In all cases, the collateral will remain subject to the security interests of subordinate lien creditors.
- b. The security interest under which the sale was made and any security interest or lien subordinate to it will be discharged.
- c. In all cases, Bonn may **not** buy the collateral at a private sale.
- d. Bonn will be entitled to receive a first priority in the sale proceeds.

N87#41. Wurke, Inc., manufactures and sells household appliances on credit directly to wholesalers, retailers, and consumers. Wurke can perfect its security interest in the appliances without having to file a financing statement or take possession of the appliances if the sale is made by Wurke to

- a. Retailers.
- b. Wholesalers that then sell to distributors for resale.
- c. Consumers.
- d. Wholesalers that then sell to buyers in the ordinary course of business.

N87#42. In order for a security interest in goods to attach, one of the requirements is that the debtor must

- a. Sign a financing statement that adequately describes the goods.

- b. Sign a security agreement that adequately describes the goods.
- c. Receive the goods from the creditor.
- d. Have rights in the goods.

N87#43. On May 8, Westar Corp. sold 20 typewriters to Saper for use in Saper's business. Saper paid for the typewriters by executing a promissory note that was secured by the typewriters. Saper also executed a security agreement. On May 9, Saper filed a petition in bankruptcy and a trustee was appointed. On May 16, Westar filed a financing statement covering the typewriters. Westar claims that it has a superior interest in the typewriters. The trustee in bankruptcy disagrees. Which of the parties is correct?

- a. The trustee, because the filing of a petition in bankruptcy cuts off Westar's rights as of the date of filing.
- b. The trustee, because the petition was filed prior to Westar's filing of the financing statement.
- c. Westar, because it perfected its security interest within ten days after Saper took possession of the typewriters.
- d. Westar, because its security interest was automatically perfected upon attachment.

N87#44. Bean defaulted on a promissory note payable to Gray Co. The note was secured by a piece of equipment owned by Bean. Gray perfected its security interest on May 29, 1987. Bean had also pledged the same equipment as collateral for another loan from Smith Co. after he had given the security interest to Gray. Smith's security interest was perfected on June 30, 1987. Bean is current in his payments to Smith. Subsequently, Gray took possession of the equipment and sold it at a private sale to Walsh, a good faith purchaser for value. Walsh will take the equipment

- a. Free of Smith's security interest because Bean is current in his payments to Smith.
- b. Free of Smith's security interest because Walsh acted in good faith and gave value.
- c. Subject to Smith's security interest because the equipment was sold at a private sale.
- d. Subject to Smith's security interest because Smith is a purchase money secured creditor.

N87#56. On March 1, Dun purchased \$50,000 of equipment from Lux Corp. for use in Dun's manufacturing process. Dun paid for the equipment with funds borrowed from Best Bank that same day. Dun executed a security agreement and financing statement covering Dun's existing and after-acquired equipment. On March 7, Dun was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code and a trustee in bankruptcy was appointed.

On March 9, Best properly filed the financing statement. Which of the parties will have a superior security interest in the equipment?

- Best, because it perfected its security interest within the permissible time limits.
- Best, because it had a perfected purchase money security interest without having to file a financing statement.
- The trustee in bankruptcy because the trustee became a lien creditor prior to the time Best perfected its security interest.
- The trustee in bankruptcy because the filing of the financing statement after the commencement of the bankruptcy case would be deemed a preferential transfer.

M87#58. Which of the following requirements is **not** necessary in order to have a security interest attach?

- There must be a proper filing.
- Value must be given by the creditor.
- Either the creditor must take possession or the debtor must sign a security agreement that describes the collateral.
- The debtor must have rights in the collateral.

M87#59. If a manufacturer assigns 90% of its accounts receivable to a factor, perfection will occur by

	<u>Filing a financing statement</u>	<u>Possession</u>	<u>Attachment</u>
a.	Yes	Yes	No
b.	Yes	No	No
c.	No	No	Yes
d.	No	Yes	No

M87#60. On May 4, Tint, a computer wholesaler, purchased 30 computers. This comprised Tint's entire inventory and was financed under an agreement with Dome Bank which gave the bank a security interest in all computers on the premises, all future acquired computers, and the proceeds of sales. On May 8, Dome filed a financing statement that adequately identified the collateral. On June 9, Tint sold one computer to Bean for personal use and four computers to Green Co. for its business. Which of the following is correct?

- The computer sold to Bean will **not** be subject to Dome's security interest.
- The computers sold to Green will be subject to Dome's security interest.
- The security interest does **not** include the proceeds from the sale of the computers to Green.
- The security interest may **not** cover after-acquired property even if the parties agree.

N86#49. Under the UCC, which of the following is correct regarding the disposition of collateral by a secured creditor after the debtor's default?

- It is improper for the secured creditor to purchase the collateral at a public sale.
- The collateral must be disposed of at a public sale.

- A good faith purchaser for value and without knowledge of any defects in the sale takes free of any subordinate liens or security interests.
- Secured creditors with subordinate claims retain the right to redeem the collateral after the disposition of the collateral to a third party.

N86#50. The perfection of a security interest by filing a financing statement

- Serves to protect the secured party's interest in the collateral against most creditors who acquire a security interest in the same collateral after the filing.
- Is necessary to enable the secured party to enforce its security interest against the debtor.
- Serves to give the public actual notice.
- Gives the secured party priority over all other parties who acquire an interest in the collateral after the filing.

N86#52. In order for a security interest in goods to attach, the

- Debtor must sign a security agreement which adequately describes the goods.
- Debtor must retain possession of the goods until the underlying debt has been satisfied.
- Creditor must properly file a financing statement.
- Creditor must have given value.

M86#38. The UCC establishes the rights of a secured creditor of a merchant in relation to various types of third parties. Regarding these third parties, which of the following is most likely to have an interest superior to that of a secured party who has a prior perfected security interest?

- Purchasers from the merchant in the ordinary course of business.
- General creditors of the merchant.
- Lien creditors of the merchant.
- Trustee in bankruptcy.

M86#39. Cross has an unperfected security interest in the inventory of Safe, Inc. The unperfected security interest

- Is superior to the interest of subsequent lenders who obtain a perfected security interest in the property.
- Is subordinate to lien creditors of Safe who become such prior to any subsequent perfection by Cross.
- Causes Cross to lose important rights against Safe as an entity.
- May only be perfected by Cross filing a financing statement.

N85#49. A typewriter, which was subject to a prior UCC security interest, was delivered to Ed Fogel for repair. Fogel is engaged in the business of repairing typewriters. Fogel repaired the typewriter. However,

Selected Questions

the owner of the typewriter now refuses to pay for the services performed by Fogel. The state in which Fogel operates his business has a statute which gives Fogel a mechanics lien on the typewriter. Fogel's mechanics lien

- a. Takes priority over a prior perfected security interest under all circumstances.
- b. Is subject to a prior perfected purchase money security interest under all circumstances.
- c. Is subject to a prior unperfected security interest where the statute is silent as to priority.
- d. Takes priority over a prior perfected security interest unless the statute expressly provides otherwise.

N85#50. Under the UCC, collateral which has been sold in a private sale by a secured party to a good faith purchaser for value after the debtor's default

- a. May be redeemed by the debtor within 10 days after the disposition.
- b. May be redeemed by creditors with subordinate claims.
- c. Remains subject to the security interests of subordinate lien creditors in all cases where the collateral is disposed of at a private sale.
- d. Discharges the security interest pursuant to which such sale was made and any security interest or lien subordinate thereto.

M85

Items 44 and 45 are based on the following information:

On June 3, Muni Finance loaned Page Corp. \$20,000 to purchase four computers for use in Page's trucking business. Page contemporaneously executed a promissory note and security agreement. On June 7, Page purchased the computers with the \$20,000, obtaining possession that same day. On June 10, Mort, a judgment creditor of Page, levied on the computers.

44. Which of the following statements is correct?
 - a. Muni failed to qualify as a purchase money secured lender.
 - b. Muni's security interest attached on June 3.
 - c. Muni's security interest attached on June 7.
 - d. Muni's security interest did **not** attach.
45. If Muni files a financing statement on June 11, which of the parties will have a priority security interest in the computers?
 - a. Mort, since he lacked notice of Muni's security interest.
 - b. Mort, since Muni failed to file before Mort levied on the computers.
 - c. Muni, since its security interest was perfected within the permissible time limits.
 - d. Muni, since its security interest was automatically perfected upon attachment.

M85#46. Perfection of a security interest under the UCC by a creditor provides added protection against

other parties in the event the debtor does not pay his debts. Which of the following is **not** affected by perfection of a security interest?

- a. The trustee in a bankruptcy proceeding.
- b. A buyer in the ordinary course of business.
- c. A subsequent personal injury judgment creditor.
- d. Other prospective creditors of the debtor.

M85

Items 47 and 48 are based on the following information:

Foxx purchased a stereo for personal use from Dix Audio, a retail seller of appliances. Foxx paid 30% of the \$600 sales price and agreed to pay the balance in 12 equal principal payments plus interest. Foxx executed a security agreement giving Dix a security interest in the stereo. Dix properly filed a financing statement immediately. After making six payments Foxx defaulted.

47. If Dix takes possession of the stereo, it
 - a. Must dispose of the stereo at a public sale.
 - b. Must dispose of the stereo within 90 days after taking possession or be liable to the debtor.
 - c. May retain possession of the stereo, thereby discharging Foxx of any deficiency.
 - d. May retain possession of the stereo and collect any deficiency plus costs from Foxx.
48. If after making the third installment payment, Foxx sold the stereo to Lutz for personal use, who would have a superior interest in the stereo assuming Lutz lacked knowledge of Dix's security interest?
 - a. Dix, since it filed a financing statement.
 - b. Dix, since more than 30% of the purchase price had been paid.
 - c. Lutz, since title passed from Foxx to Lutz.
 - d. Lutz, since he purchased without knowledge of Dix's security interest and for personal use.

M85#49. Cole purchased furniture for her home from Thrift Furniture. The contract required Cole to pay 10% cash and the balance in equal installments over 36 months. Cole signed a security agreement with the furniture listed as collateral. Thrift properly filed a financing statement. If Cole makes the final payment due on the contract, Thrift

- a. Must file a termination statement **no** later than one month after final payment in order to avoid liability unless Cole demands earlier filing.
- b. Must file a termination statement in order to avoid liability only if Cole makes a written demand.
- c. Does **not** have to file a termination statement since the collateral is consumer goods.
- d. Does **not** have to file a termination statement since the term of the financing statement is less than five years and will automatically terminate.

Business Law

M85#50. Minor Corp. manufactures exercise equipment for sale to health clubs and to retailers. Minor also sells directly to consumers in its wholly-owned retail outlets. Minor has created a subsidiary, Minor Finance Corp., for the purpose of financing the purchase of its products by the various customers. In which of the following situations does Minor Finance **not** have to file a financing statement to perfect its security in-

terest against competing creditors in the equipment sold by Minor?

- Sales made to retailers who in turn sell to buyers in the ordinary course of business.
- Sales made to any buyer when the equipment becomes a fixture.
- Sales made to health clubs.
- Sales made to consumers who purchase for their own personal use.

VII. Property

A. Real and Personal Property

N88#56. Green and Nunn own a 40-acre parcel of land as joint tenants with the right of survivorship. Nunn wishes to sell the land to Ink. If Nunn alone executes and delivers a deed to Ink, what will be the result?

- Green will retain a $\frac{1}{2}$ undivided interest in the 40-acre parcel, and will be unable to set aside Nunn's conveyance to Ink.
- Ink will obtain an interest in $\frac{1}{2}$ of the parcel, or 20 acres.
- Ink will share ownership of the 40 acres with Green as a joint tenant with a right of survivorship.
- The conveyance will be invalid because Green did **not** sign the deed.

N88#57. Tell, Inc. leased a building from Lott Corp. Tell paid monthly rent of \$500 and was also responsible for paying the building's real estate taxes. On January 1, 1987, Vorn Co. and Tell entered into an agreement by which Vorn was entitled to occupy the building for the remainder of the term of Tell's lease in exchange for monthly payments of \$600 to Tell. For the year 1987, neither Tell nor Vorn paid the building's real estate taxes and the taxes are delinquent. Learning this, Lott demanded that either Tell or Vorn pay the delinquent taxes. Both refused to do so and Lott has commenced an action against them. Lott will most likely prevail against

- Vorn because the lease was assigned to it.
- Tell and Vorn because both are jointly and severally liable for the delinquent taxes.
- Tell without Vorn because their January 1 agreement constituted a sublease.
- Vorn but only to the extent of \$100 for each month that it occupied the building during 1987.

N88#58. Which of the following deeds gives the grantee the **least** amount of protection?

- Bargain and sale deed.
- Grant deed.
- Quitclaim deed.
- Warranty deed.

M88#51. A purchaser of real property who wishes to receive the broadest protection with respect to the property being conveyed should obtain a

- Bargain and sale deed.
- General warranty deed.
- Quitclaim deed.
- Grant deed.

M88

Items 53 and 54 are based on the following information:

Boch and Kent are equal owners of a warehouse. Boch died leaving a will that gave his wife all of his right, title, and interest in his real estate.

53. If Boch and Kent owned the warehouse at all times as joint tenants with the right of survivorship, Boch's interest

- Will pass to his wife after the will is probated.
- Will **not** be included in his gross estate for federal estate tax purposes.
- Could **not** be transferred before Boch's death without Kent's consent.
- Passed to Kent upon Boch's death.

54. If Boch and Kent owned the warehouse at all times as tenants in common, which of the following statements is correct?

- Boch's interest will pass to his wife after the will is probated.
- Upon Boch's death, all tenancies in common terminated.
- Boch's interest will **not** be included in his gross estate for federal estate tax purposes.
- Upon Boch's death, his interest passed to Kent.

M88#55. Sisk is a tenant of Met Co. and has two years remaining on a six-year lease executed by Sisk and Met. The lease prohibits subletting but is silent as to Sisk's right to assign the lease. Sisk assigned the lease to Kern Corp. which assumed all of Sisk's obligations under the

Selected Questions

lease. Met objects to the assignment. Which of the following statements is correct?

- a. The assignment to Kern is voidable at Met's option.
- b. Sisk would have been relieved from liability on the lease with Met if Sisk obtained Met's consent to the assignment.
- c. Sisk will remain liable to Met for the rent provided for in the lease.
- d. With respect to the rent provided for in the lease, Kern is liable to Sisk but **not** to Met.

N87#53. Which of the following factors is **least** significant in determining whether an item of personal property has become a fixture?

- a. The extent of injury that would be caused to the real property by the removal of the item.
- b. The value of the item.
- c. The manner of attachment.
- d. The adaptability of the item to the real estate.

N87

Items 54 and 55 are based on the following information:

Hill, Knox, and Lark own a building as joint tenants with the right of survivorship. Hill donated her interest in the building to Care Charity by executing and delivering a deed to Care. Both Knox and Lark refused to consent to Hill's transfer to Care. Subsequently, Hill and Knox died.

54. As a result of Hill's transfer to Care, Care acquired

- a. A $\frac{1}{3}$ interest in the building as a joint tenant.
- b. A $\frac{1}{3}$ interest in the building as a tenant in common.
- c. No interest in the building because Knox and Lark refused to consent to the transfer.
- d. No interest in the building because it failed to qualify as a bona fide purchaser for value.

55. As a result of Hill's and Knox's death,

- a. Lark owns the entire interest in the building.
- b. Lark owns a $\frac{2}{3}$ interest in the building as a tenant in common.
- c. Care and Lark each own a $\frac{1}{2}$ interest in the building as joint tenants.
- d. Knox's heirs and Lark each own a $\frac{1}{3}$ interest in the building as tenants in common.

N87#56. Drake Corp. entered into a five-year lease with Samon that provided for Drake's occupancy of three floors of a high-rise office building at a monthly rent of \$16,000. The lease provided that "lessee may sublet the premises but only with the landlord's (Samon's) prior written consent". The lease was silent as to whether Drake could assign the lease. Which of the following statements is correct?

- a. Subletting of the premises with Samon's consent will relieve Drake from its obligation to pay rent.

- b. Assignment of the lease with Samon's consent will relieve Drake from its obligation to pay rent.
- c. Samon may refuse to consent to a subsequent sublet even if she has consented to a prior sublet.
- d. Subletting of the premises without Samon's consent is void.

N87#57. A purchaser of a building who receives real estate title insurance will

- a. Not have coverage for the title exceptions listed in the policy.
- b. Have coverage for title defects that result from events that happen after the effective date of the policy.
- c. Be entitled to transfer the policy to subsequent owners since the policy runs with the property being insured.
- d. Take title to the building free and clear of all record defects since all exceptions to title must be cleared prior to closing.

N86

Items 56 and 57 are based on the following information:

On July 1, 1986, A, B, C, and D purchased a parcel of land as tenants in common each owning an equal share. On July 10, A died leaving a will. Subsequently, B died intestate.

56. After A and B's death,

- a. C and D will each own a $\frac{1}{2}$ interest in the land.
- b. C and D will each own a $\frac{1}{4}$ interest in the land.
- c. C and D will each own a $\frac{1}{3}$ interest in the land.
- d. The tenancy in common will terminate.

57. If C sells her interest in the land to X,

- a. The tenancy in common will terminate.
- b. D and X will each own a $\frac{1}{2}$ interest in the land.
- c. D and X will each own a $\frac{1}{3}$ interest in the land.
- d. D and X will each own a $\frac{1}{4}$ interest in the land.

N86#58. Which of the following warranty (warranties) is (are) given by a general warranty deed?

- I. The grantor owns the property being conveyed.
- II. The grantee will **not** be disturbed in her possession of the property by the grantor or some third party's lawful claim of ownership.
- III. The grantor has the right to convey the property.

- a. I only.
- b. I, II, and III.
- c. I and III only.
- d. II and III only.

N86#41. Mack & Watts, CPAs, wishes to relocate its office. Its existing lease is for four years, with one year remaining. Its landlord is not agreeable to canceling the lease. The lease also prohibits a sublease without the landlord's consent but is silent as to an assignment.

Business Law

Mack & Watts has found a financially responsible and respectable prospective subtenant but is convinced that the landlord will not consent to a sublease. Which of the following statements is correct?

- a. A sublease without the landlord's consent would **not** be a breach of the lease.
- b. An assignment by Mack & Watts would be a breach of the lease.
- c. An assignment by Mack & Watts would **not** relieve it of liability under the lease.
- d. A sublease with the landlord's consent would relieve Mack & Watts of liability under the lease.

M86#42. In order for a deed to be effective between the purchaser and seller of real estate, the deed must be

- a. Delivered by the seller with an intent to transfer title.
- b. Recorded within the permissible statutory time limits.
- c. In writing and signed by the seller and purchaser.
- d. Essentially in the same form as the contract for purchase and sale and include the actual sales price.

M86

Items 43 and 44 are based on the following information:

Abel, Boyd, and Cox are relatives who own a parcel of undeveloped land as joint tenants with right of survivorship. Abel sold his interest in the land to Zahn.

- 43. As a result of the sale from Abel to Zahn,
 - a. Zahn will acquire a $\frac{1}{3}$ interest in the land as a joint tenant.
 - b. Zahn will acquire a $\frac{1}{3}$ interest in the land as a tenant in common.
 - c. Boyd and Cox will each own a $\frac{1}{3}$ interest in the land as tenants in common.
 - d. Boyd and Cox must consent before Zahn will acquire any interest in the land.
- 44. If both Boyd and Zahn die, which of the following is correct with respect to the ownership of the land?
 - a. Cox and Zahn's heirs are tenants in common with ownership interests as follows: Cox $\frac{2}{3}$ and Zahn's heirs $\frac{1}{3}$.
 - b. Cox and Zahn's heirs are joint tenants with ownership interests as follows: Cox $\frac{2}{3}$ and Zahn's heirs $\frac{1}{3}$.
 - c. Cox, Boyd's heirs, and Zahn's heirs each own a $\frac{1}{3}$ interest as tenants in common.
 - d. Cox owns the entire interest.

M86#45. Frey Products, Inc., leased ten lathes from Tri Corp., a manufacturer of lathes. The lease provided for monthly payments of \$2,000 per month for 60

months. Frey has an option to purchase the ten lathes for \$200 upon completion of the 60 payments. Tri has accounted for this lease as a sales-type lease and Frey has accounted for this lease as a capital lease. Assuming Frey exercises the option, which of the following statements is correct?

- a. Frey lacks an insurable interest in the lathes until it exercises the option to purchase them.
- b. The lease agreement represents a purchase money security interest which is automatically perfected without the necessity of filing a financing statement.
- c. In order to have an enforceable lease Tri must file a security agreement.
- d. Title to the lathes passed to Frey prior to the time Frey exercised the option.

M86#46. Dash has agreed to sell a warehouse for \$300,000 to Bosch. The contract provided that Dash will convey to Bosch whatever interest Dash may have in the warehouse. Under the terms of the contract, Bosch is entitled to receive a(an)

- a. Insurable deed.
- b. Quitclaim deed.
- c. General warranty deed.
- d. Special warranty deed.

N85

Items 51 and 52 are based on the following information:

Mini, Inc., entered into a five-year lease with Rein Realtors. The lease was signed by both parties and immediately recorded. The leased building was to be used by Mini in connection with its business operations. To make it suitable for that purpose, Mini attached a piece of equipment to the wall of the building.

- 51. Which of the following is most important in determining whether the equipment became a fixture?
 - a. Whether the equipment can be removed without material damage to the building.
 - b. Whether the attachment is customary for the type of building.
 - c. The fair market value of the equipment at the time the lease expires.
 - d. The fact that the equipment was subject to depreciation.
- 52. Which of the following statements is correct regarding Mini's rights and liabilities?
 - a. Mini is prohibited from assigning the lease if it is silent in this regard.
 - b. Mini has a possessory interest in the building.
 - c. Mini is strictly liable for all injuries sustained by any person in the building during the term of the lease.
 - d. Mini's rights under the lease are automatically terminated by Rein's sale of the building to a third party.

Selected Questions

N85#53. Jane and her brother each own a $\frac{1}{2}$ interest in certain real property as tenants in common. Jane's interest

- a. Is considered personal property.
- b. Will pass to her brother by operation of law upon Jane's death.
- c. Will pass upon her death to the person Jane designates in her will.
- d. May **not** be transferred during Jane's lifetime without her brother's consent.

N85#54. Real estate title insurance

- a. May be transferred to a subsequent bona fide purchaser for value.
- b. Assures that the purchaser will take title free and clear of all defects.
- c. Assures that the purchaser will take title free and clear of all record defects since all exceptions to title must be cleared prior to the purchaser taking possession of the realty.
- d. Is generally **not** required where the contract is silent on this point.

M85

Items 52 and 53 are based on the following information:

On July 1, Bean deeded her home to Park. The deed was never recorded. On July 5, Bean deeded the same home to Noll. On July 9, Noll executed a deed, conveying his title to the same home to Baxter. On July 10, Noll and Baxter duly recorded their respective deeds.

52. In order for Noll's deed from Bean to be effective it must

- a. Contain the actual purchase price paid by Noll.
- b. Be signed by Noll.
- c. Include a satisfactory description of the property.
- d. Be recorded with Bean's seal affixed to the deed.

53. If Noll and Baxter are bona fide purchasers for value, which of the following statements is correct?

- a. Baxter's interest is superior to Park's.
- b. Bean's deed to Park was void as between Bean and Park because it was **not** recorded.
- c. Bean's deed to Noll was void because she had **no** interest to convey.
- d. Baxter can recover the purchase price from Noll.

M85#54. In order to create an easement by prescription a person must, in addition to fulfilling other requirements, have

- a. Recorded the easement immediately upon its creation.
- b. Received the express or implied consent of the true owner.
- c. Used the land of another out of necessity.
- d. Used the land of another in a manner that is open and notorious.

B. Mortgages

N88#59. In general, a mortgage on real estate

- a. Must be recorded to validate the mortgagee's (lender's) rights against the mortgagor (borrower).
- b. Must be signed by the mortgagee and mortgagor to create an enforceable instrument.
- c. Encumbers the mortgagor's legal title to the real estate.
- d. Gives the mortgagee the right to possess the real estate.

N88#60. In 1982, Smith gave a mortgage to State Bank to secure a \$100,000 loan. The mortgage was silent as to whether it would secure any other loans made by State to Smith. In 1984 Smith gave a second mortgage to Penn Bank to secure an \$80,000 loan. Both mortgages described the same land and were properly recorded shortly after being executed by Smith. By 1988 Smith had repaid State Bank \$40,000 of the \$100,000 debt. State Bank then loaned Smith an additional \$20,000 without taking any new security. Within a few days, Smith defaulted on the loans from both banks and the first and second mortgages were foreclosed. The balance on the Penn loan was \$20,000. The net proceeds of the foreclosure sale were \$70,000. State is entitled to receive from the proceeds a maximum of

- a. \$52,500.
- b. \$56,000.
- c. \$60,000.
- d. \$70,000.

M88#52. In general, which of the following statements is correct with respect to a real estate mortgage?

- a. The mortgage must be in writing and signed by both the mortgagor (borrower) and mortgagee (lender).
- b. The mortgagee may assign the mortgage to a third party without the mortgagor's consent.
- c. The mortgage need **not** contain a description of the real estate covered by the mortgage.
- d. The mortgage must contain the actual amount of the underlying debt and the rate of interest.

M88#56. Bell obtained a \$30,000 loan from Arco Bank, executing a promissory note and mortgage. The loan was secured by a building that Bell purchased from Marx for \$50,000. Arco's recording of the mortgage

- a. Generally does **not** affect the rights of Bell and Arco against each other under the promissory note.
- b. Generally creates a possessory security interest in Arco.
- c. Cuts off the rights of all prior and subsequent lessees of the building.
- d. Transfers legal title to the building to Arco.

M88#57. On April 6, 1988, Walsh purchased a warehouse from Bock for \$150,000. Best Title Co. had performed a title search of the property. The results of the title search indicated that a mortgage given to Stone by

Bock was duly recorded against the warehouse on March 9, 1988. However, the title search failed to detect a purchase money mortgage dated March 2, 1988, given by Bock to Todd. This mortgage was never recorded. Walsh was unaware of the mortgage to Todd. Under the circumstances,

- a. Walsh will take title to the warehouse subject to Todd's mortgage because it is a purchase money mortgage.
- b. Walsh will take title to the warehouse free of Todd's mortgage.
- c. Todd's mortgage is superior to Stone's mortgage.
- d. Best will be liable to Walsh because of its failure to detect the Todd mortgage.

M88#58. Shea Corp. owns a factory that has a fair market value of \$50,000. Deal Bank holds a first mortgage and Rift Finance holds a second mortgage on the factory. Shea has discontinued payments to Deal and Rift. As a result, Deal, which is owed \$45,000, and Rift, which is owed \$15,000, have foreclosed on their respective mortgages. If the factory is properly sold to Bean at a judicial sale for \$50,000, after expenses,

- a. Deal will receive \$37,500 out of the proceeds.
- b. Rift will receive \$5,000 out of the proceeds.
- c. Rift has a right of redemption after the judicial sale.
- d. Bean will take the factory subject to the unsatisfied portion of any mortgage.

N87#51. Fine Bank loaned Aker \$80,000 to purchase a condominium. Aker executed a promissory note and a mortgage that encumbered the condominium. Fine failed to record the mortgage. With respect to the above transaction, Fine

- a. Will hold legal title to the condominium until the note is paid.
- b. Must file a financing statement to perfect its security interest in the condominium, because the condominium is personal property.
- c. Must sign the note and mortgage in order for them to be effective.
- d. Is entitled to collect the \$80,000 from Aker despite its failure to record the mortgage.

N87#52. Lusk borrowed \$20,000 from Marco Finance. The loan was secured by a mortgage on a four-unit apartment building owned by Lusk. The proceeds of the loan were used by Lusk to purchase a business. The mortgage was duly recorded 60 days after Marco loaned the money to Lusk. Six months after borrowing the money from Marco, Lusk leased one of the apartments to Rudd for \$800 per month. Neither Rudd nor Lusk notified Marco of the lease. Subsequently, Lusk defaulted on the note to Marco and Marco has commenced foreclosure proceedings. Under the circumstances,

- a. Marco's mortgage is junior to Rudd's lease because the mortgage was **not** a purchase money mortgage.

- b. Marco's mortgage is junior to Rudd's lease because Marco failed to record the mortgage for 60 days after the closing.
- c. Rudd's lease is subject to Marco's mortgage because Marco recorded its mortgage prior to the time Rudd's leasehold interest arose.
- d. Rudd's lease is subject to Marco's mortgage because of the failure to notify Marco of the lease.

N86#53. Which of the following statements is correct with respect to a real estate mortgage?

- a. It must be signed only by the mortgagor (borrower).
- b. It must be recorded in order to be effective between the mortgagor and mortgagee.
- c. It does **not** have to be recorded to be effective against third parties without notice if it is a purchase money mortgage.
- d. It is effective even if **not** delivered to the mortgagee.

N86#54. Watts gave a mortgage on a vacant lot to Fast to secure payment of a note. Fast assigned the note and mortgage to Beal who paid 85% of the face value for it. Neither Fast nor Beal recorded the mortgage. Subsequently, Fast assigned the same note and mortgage to Rusk who paid 75% of the face value for it and who had no notice of the prior assignment to Beal. Rusk promptly recorded the mortgage and the assignment. Watts has made no payments on the note. The jurisdiction has a notice-type of recordation statute. Under the circumstances

- a. The assignments to Beal and Rusk are ineffective because Fast failed to record the mortgage.
- b. Equity will require that Beal and Rusk share in the proceeds of the note equally as their interests may appear.
- c. Rusk is entitled to recover only 75% of the face value of the note.
- d. Rusk is entitled to the full face amount of the Watts note.

N86#55. In a notice-type recordation jurisdiction, failure by the mortgagee to record its mortgage

- a. Releases the mortgagor (borrower) from the underlying obligation to pay.
- b. Permits a subsequent mortgagee without knowledge of the prior mortgage to have a superior security interest.
- c. Permits a subsequent purchaser for value with knowledge of the mortgage to take the property free of the prior security interest.
- d. Permits a subsequent mortgagee with knowledge of the prior mortgage to have a superior security interest provided he promptly records his mortgage.

Selected Questions

M86#47. Which of the following statements pertaining to a mortgage on a building is **incorrect**?

- a. The mortgagor customarily retains legal title to the building despite the mortgage.
- b. The recording of the mortgage is necessary to validate the rights and liabilities of the mortgagor and mortgagee against each other.
- c. The mortgage must be in writing and signed by the mortgagor.
- d. The mortgage must contain a description of the property subject to the mortgage.

M86#48. Which of the following statements regarding the recording of a real estate mortgage in a state having a notice-race statute is correct?

- a. By recording, the mortgagee will acquire additional rights against the mortgagor.
- b. The mortgagee must file a financing statement with the appropriate state agency.
- c. The recording of a mortgage is necessary to defeat the claims of a purchaser for value who had knowledge of the mortgage.
- d. The recording of the mortgage will be important in determining priority among parties who claim an interest in the real estate.

M86#49. Glenn borrowed \$80,000 from City Bank. He executed a promissory note and secured the loan with a mortgage on business real estate he owned as a sole proprietor. Glenn neglected to advise City that he had previously mortgaged the property to Ball, who had failed to record his mortgage. City promptly recorded its mortgage. Subsequently, Glenn conveyed his business assets including the property to a newly created corporation in exchange for all of its stock. Which of the following is correct?

- a. Ball's mortgage is prior in time and would take priority over City's mortgage.
- b. Glenn's corporation will take the property subject to both mortgages.
- c. The corporation will be deemed to have assumed both mortgages.
- d. On foreclosure, Glenn could **not** be called upon to pay City any deficiency.

N85

Items 55 and 56 are based on the following information:

On June 1, 1985, Byrd Corp. purchased a high-rise building from Slade Corp. for \$375,000. The building was encumbered by a mortgage and note dated May 1, 1980 executed by Slade. The mortgage had been duly recorded by the mortgagee, Fale Bank. The outstanding balance on the mortgage at the time of Byrd's purchase was \$300,000. Byrd acquired the property subject to the mortgage held by Fale and, in addition, gave a mortgage on the building to Foxx Finance to secure a non-purchase money promissory note in the sum of

\$50,000. Prior to any payments being made on either loan, Byrd defaulted. As a result, the building was properly sold at a foreclosure sale for \$280,000.

55. Which of the following statements is correct regarding Byrd's and Slade's liability to Fale?

- a. Byrd is liable to Fale for any deficiency.
- b. Byrd is secondarily liable to Fale as a surety.
- c. Slade was automatically released from all liability to Fale upon Byrd's acquisition of the building subject to the mortgage.
- d. Slade is liable to Fale for any resulting deficiency.

56. As a result of the foreclosure sale

- a. Fale is entitled to receive the full \$280,000 out of the proceeds.
- b. Fale is entitled to receive \$240,000 out of the proceeds.
- c. Foxx is entitled to receive its full \$50,000 from either Byrd or Slade.
- d. Foxx is entitled to receive \$50,000 out of the proceeds.

M85#55. Lake purchased a home from Walsh for \$95,000. Lake obtained a \$60,000 loan from Safe Bank to finance the purchase, executing a promissory note and mortgage. The recording of the mortgage by Safe

- a. Gives the world actual notice of Safe's interest.
- b. Protects Safe's interest against the claims of subsequent bona fide purchasers for value.
- c. Is necessary in order that Safe have rights against Lake under the promissory note.
- d. Is necessary in order to protect Safe's interest against the claim of a subsequent transferee who does **not** give value.

M85#56. Gray owned a warehouse free and clear of any encumbrances. Gray borrowed \$30,000 from Harp Finance and executed a promissory note secured by a mortgage on the warehouse. The state within which the warehouse was located had a notice-race recording statute applicable to real property. Harp did not record its mortgage. Thereafter, Gray applied for a loan with King Bank, supplying King with certified financial statements which disclosed Harp's mortgage. After review of the financial statements, King approved Gray's loan for \$25,000, taking an executed promissory note secured by a mortgage on the warehouse. King promptly recorded its mortgage. Which party's mortgage will be superior?

- a. Harp's, since King had notice of Harp's interest.
- b. Harp's, since it obtained a purchase money security interest.
- c. King's, since it was the first to file.
- d. King's, since a title search would fail to reveal Harp's interest.

M85#57. A mortgagor who defaults on his mortgage payments will **not** be successful if he attempts to

- Assert the equitable right to redeem.
- Redeem the property after a judicial foreclosure sale has taken place.
- Obtain any excess resulting from a judicial foreclosure sale.
- Contest the validity of the price received at a judicial foreclosure sale by asserting that a higher price could have been received at a later date.

C. Fire and Casualty Insurance

M88#59. On April 2, 1987, Ritz Corp. purchased a warehouse that it insured for \$500,000. The policy contained a 75% coinsurance clause. On April 25, 1988, a fire caused \$900,000 damage to the warehouse. The fair market value of the warehouse was \$800,000 on April 2, 1987, and \$1 million on April 25, 1988. Ritz is entitled to receive insurance proceeds of, at most,

- \$375,000.
- \$500,000.
- \$600,000.
- \$750,000.

M88#60. Beal occupies an office building as a tenant under a 25-year lease. Beal also has a mortgagee's (lender's) interest in an office building owned by Hill Corp. In which capacity does Beal have an insurable interest?

	<u>Tenant</u>	<u>Mortgagee</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

N87#58. In general, the coinsurance feature of property insurance

- Is fixed at a minimum of 80% by law.
- Is an additional refinement of the insurable interest requirement.
- Precludes the insured from insuring for less than the coinsurance percentage.
- Prevents the insured from insuring for a minimal amount and recovering the full amount of losses.

N87#59. With respect to property insurance, the insurable interest requirement

- Need only be satisfied at the time the policy is issued.
- Must be satisfied both at the time the policy is issued and at the time of the loss.
- Will be satisfied only if the insured owns the property in fee simple absolute.
- Will be satisfied by an insured who possesses a leasehold interest in the property.

N87#60. On May 5, Sly purchased a warehouse for \$100,000. Sly immediately insured the warehouse in the amount of \$40,000 with Riff Insurance Co. Six months later, Sly obtained additional fire insurance on the warehouse in the amount of \$10,000 from Beek Insurance Co. Both policies contained an 80% coinsurance clause. Sly failed to notify Riff of the policy with Beek. Two years later, while both policies were still in effect, a fire caused by Sly's negligence resulted in \$20,000 of damage to the warehouse. At the time of the loss, the warehouse had a fair market value of \$50,000. Which of the following will prevent Sly from obtaining the full \$20,000 from Riff?

- Sly's negligence in causing the fire.
- Sly's failure to satisfy the coinsurance clause.
- Sly's failure to notify Riff of the policy with Beek.
- Sly's purchase of insurance from Beek.

N86#59. The earliest time a purchaser of existing goods will acquire an insurable interest in those goods is when

- The purchaser obtains possession.
- Title passes to the purchaser.
- Performance of the contract has been completed or substantially completed.
- The goods are identified to the contract.

N86#60. Long Co. owns a warehouse which is insured in the amount of \$60,000 against loss by fire. The policy contains an 80% coinsurance clause. A fire totally destroyed the warehouse which was valued at the time of the loss at \$150,000. Long is entitled to receive

- \$0, since it failed to meet the coinsurance requirements.
- \$48,000.
- \$60,000.
- \$75,000.

N85#60. West is seeking to collect on a property insurance policy covering certain described property which was destroyed. The insurer has denied recovery based upon West's alleged lack of an insurable interest in the property. In which of the situations described below will the insurance company prevail?

- West is **not** the owner of the insured property but a mere long-term lessee.
- The insured property belongs to a general trade debtor of West and the debt is unsecured.
- The insured property does **not** belong to West, but instead to a corporation which he controls.
- The property has been willed to West's father for life and, upon his father's death, to West as the remainderman.

Selected Questions

M85#59. The coinsurance clause with regard to property insurance

- a. Prohibits the insured from obtaining an amount of insurance which would be less than the coinsurance percentage multiplied by the fair market value of the property.
- b. Encourages the insured to be more careful in preventing losses since the insured is always at least partially at risk when a loss occurs.
- c. Permits the insured to receive an amount in excess of the policy amount when there has been a total loss and the insured carried the required coverage under the coinsurance clause.
- d. Will result in the insured sharing in partial losses when the insured has failed to carry the required coverage under the coinsurance clause.

M85#60. The insurable interest requirement with regard to property insurance

- a. May be waived by a writing signed by the insured and insurer.
- b. May be satisfied by a person other than the legal owner of the property.
- c. Must be satisfied at the time the policy is issued.
- d. Must be satisfied by the insured's legal title to the property at the time of loss.

SELECTED MULTIPLE CHOICE ITEMS — UNOFFICIAL ANSWERS

I. The CPA and the Law

A. Common Law Liability to Clients and Third Persons

M89# 1 b
M89# 2 b
M89# 6 b
M89# 7 c
M89# 9 c
M88# 1 b
M88# 2 b
N87# 26 d
N87# 27 d

N87# 28 c
N87# 29 d
N87# 30 b
N86# 1 c
N86# 2 b
N86# 4 a
N86# 5 a

B. Federal Statutory Liability

M89# 3 d
M89# 4 a

M89# 8 c
M89# 10 a
M88# 8 c
M88# 9 b
N87# 31 d
N87# 32 a
N87# 33 b
N87# 34 b
N86# 7 c
N86# 8 d

C. Workpapers, Privileged Communication, and Confidentiality

M89# 5 d
M88# 3 c
N87# 35 c
N86# 9 a
N86# 10 b

II. Business Organizations

A. Agency

M89# 11 b
M89# 12 b
M89# 13 c
N88# 1 a
N88# 2 a
N88# 3 d
M88# 4 a
M88# 5 d
M88# 6 b
N87# 23 b
N87# 24 b
N87# 25 a
M87# 4 d
M87# 5 a
M87# 6 d
M86# 59 a
M86# 60 d
M85# 1 d
M85# 2 b
M85# 3 a
M85# 5 c

B. Partnerships and Joint Ventures

M89# 14 b
M89# 15 d
M89# 16 a
N88# 4 a
M88# 7 a
M88# 13 c
M88# 14 d
N87# 19 b
N87# 20 b
N87# 21 b
N87# 22 c
M87# 7 c
M87# 8 a
M87# 9 b
M87# 10 b
M86# 55 b
M86# 56 c
M86# 58 a

M85# 7 b
M85# 8 d
M85# 9 b
M85# 10 a

C. Corporations

N88# 5 b
N88# 6 a
M88# 15 c
M87# 1 d
M87# 2 c
M87# 3 d
N85# 2 d
N85# 3 c
N85# 4 d
N85# 5 a
M85# 11 b
M85# 12 d
M85# 14 b
M85# 15 d

D. Estates and Trusts

M89# 17 a
M89# 18 d
M89# 19 a
M89# 20 c
N88# 7 c
N88# 8 c
N88# 9 c
M88# 10 b
M88# 11 a
M88# 12 c
N87# 16 d
N87# 17 d
N87# 18 c
M86# 51 d
M86# 52 b
M86# 53 c
M86# 54 a
N85# 58 b
M85# 58 d

III. Contracts

A. Offer and Acceptance

M89# 21 c
M89# 22 d
M89# 23 d
M89# 25 a

N88# 10 b
N88# 11 c
N88# 12 a
M88# 16 c
M88# 17 a

M87# 11 c
M87# 12 a
M87# 15 d
M87# 16 a
N86# 12 a
N86# 15 d

M86# 1 a
M86# 2 c
N85# 7 d
N85# 11 d
M85# 21 d

Business Law

B. Consideration		N88# 14 c	N85# 15 c	N85# 17 a
	M89#24 a	M88 20 d	M85#23 b	M85#26 c
	M88#18 b	M87#13 b		
	N87# 2 d	N86# 16 a	G. Mistake and Misrepresentation	J. Assignments
	M87#14 a	M86# 6 a		M89#33 d
	M87#17 c	N85# 9 d	M89#30 c	N88# 18 d
C. Capacity, Legality, and Public Policy	N86# 11 d	E. Statute of Limitations	N88# 16 d	M88#23 d
	M86# 3 b		N87# 5 a	M87#21 a
	N85# 13 a	M88#22 b	M87#22 c	N86# 24 a
		N86# 17 c	N86# 21 c	N85# 6 c
		M86# 7 c	N85# 12 d	M85#22 c
		M85#24 d	M85#19 d	
	M89#26 b	F. Fraud, Duress, and Undue Influence	H. Parol Evidence Rule	K. Discharge, Breach, and Remedies
	N88# 13 d			M89#34 d
	M88#19 a	M89#28 c	M89#31 a	M89#35 b
	N87# 3 c	N88# 15 d	M88#21 d	N88# 19 a
	M87#18 a	M88#25 c	M86#12 c	M88#24 a
	N86# 13 c	N87# 4 a	M85#25 c	N87# 1 d
D. Statute of Frauds	N86# 14 d	M87#19 c	I. Third Party Rights	M87#24 c
	M86# 4 d	M87#20 b		N86# 18 a
	M86# 5 a	N86# 19 d	M89#32 a	N86# 25 a
		N86# 20 a	N88# 17 b	M86# 9 b
		M86# 8 b	M87#23 a	M86#15 a
		M86#10 b	N86# 23 c	N85# 18 b
		N85# 10 c	M86#13 d	M85#27 d

IV. Debtor-Creditor Relationships

A. Suretyship		N86# 28 c	N88# 28 c	M87#30 b
		N85# 32 b	N88# 29 d	M87#31 c
	N88# 20 c		M88#28 a	M87#32 b
	N88# 21 c	B. Bankruptcy	M88#29 b	M87#34 a
	M88#26 d		M88#30 b	M87#35 b
	M88#27 a	N88# 22 a	M88#31 a	N85# 26 b
	M87#26 a	N88# 23 d	M88#32 d	N85# 27 a
	M87#27 b	N88# 24 b	M88#33 c	N85# 28 b
	M87#28 c	N88# 25 d	M88#34 c	N85# 29 b
	M87#29 a	N88# 26 a	M88#35 a	N85# 30 a
	M86# 26 b	N88# 27 b		

V. Government Regulation of Business

A. Regulation of Employment		M86#16 d	N88# 32 b	M87#40 c
		M86#17 c	N88# 33 d	M87#41 b
		M86#18 d	N88# 34 c	M87#42 d
	M89#36 c	N85# 21 d	M88#36 c	M87#44 a
	M89#37 d	N85# 22 c	M88#37 a	M87#45 b
	M89#38 c	M85#30 d	M88#38 a	N86# 31 d
	N88# 30 a		M88#39 c	N86# 32 d
	M88#43 c	B. Federal Securities Acts	M88#40 c	N86# 33 c
	M88#44 a		M88#41 b	N86# 34 b
	M88#45 b		M88#42 b	N86# 35 c
	N87# 13 a	M89#39 d	N87# 6 a	M86#19 b
	N87# 14 a	M89#40 d	N87# 8 c	M86#20 d
	N87# 15 c	M89#41 b	N87# 9 d	M86#21 a
	M87#36 c	M89#42 a	N87# 10 c	M86#22 b
	M87#37 a	M89#43 a	N87# 11 b	M86#24 d
	N86# 37 c	M89#44 c	N87# 12 b	M86#25 a
	N86# 38 c	M89#45 c		
	N86# 39 a	N88# 31 a	M87#39 a	

Unofficial Answers

VI. Uniform Commercial Code

A. Commercial Paper

M89#46 a
M89#48 b
M89#49 a
M89#50 b
M89#51 a
M89#52 c
M89#59 b
N88#35 b
N88#36 a
N88#37 c
N88#38 d
N88#39 a
N88#40 d
N88#41 d
M88#46 d
M88#47 d
M88#48 d
N87#45 c
N87#46 c
N87#47 c
N87#48 b
N87#49 c
N87#50 c
M87#46 b
N86#40 a
N86#41 d
N86#43 b
N86#44 d
M86#26 b
M86#28 c
M86#29 c
M86#30 d

M86#31 c
N85#36 c
N85#37 c
N85#38 d
N85#39 b
N85#40 a
N85#41 a
N85#42 b
N85#43 c
M85#33 a
M85#34 c
M85#35 a
M85#36 d
M85#37 b
M85#38 d
M85#39 d

**B. Documents of Title
and Investment
Securities**

M89#53 d
N88#42 b
M88#49 a
N87#36 a
M87#47 d
N86#48 b
N85#45 c
M85#40 c

C. Sales

M89#54 c
M89#55 d

M89#56 b
M89#57 c
M89#58 b
N88#43 c
N88#44 d
N88#45 a
N88#46 d
N88#47 d
N88#48 d
N88#49 b
N88#50 d
N88#51 d
M88#50 d
N87#37 a
N87#38 a
N87#39 b
N87#40 d
M87#48 a
M87#49 c
M87#50 b
M87#52 a
M87#53 b
M87#54 b
M87#55 b
N86#46 b
N86#47 d
M86#33 c
M86#34 d
N85#46 d
N85#47 b
N85#48 b

M85#42 c
M85#43 c

D. Secured Transactions

M89#47 c
M89#60 a
N88#52 b
N88#53 a
N88#54 a
N88#55 b
N87#41 c
N87#42 d
N87#43 c
N87#44 b
M87#56 a
M87#58 a
M87#59 b
M87#60 a
N86#49 c
N86#50 a
N86#52 d
M86#38 a
M86#39 b
N85#49 d
N85#50 d
M85#44 c
M85#45 c
M85#46 b
M85#47 b
M85#48 a
M85#49 a
M85#50 d

VII. Property

**A. Real and Personal
Property**

N88#56 a
N88#57 c
N88#58 c
M88#51 b
M88#53 d
M88#54 a
M88#55 c
N87#53 b
N87#54 b
N87#55 b
N87#56 c
N87#57 a
N86#56 b

N86#57 d
N86#58 b
M86#41 c
M86#42 a
M86#43 b
M86#44 a
M86#45 d
M86#46 b
N85#51 a
N85#52 b
N85#53 c
N85#54 d
M85#52 c
M85#53 a
M85#54 d

B. Mortgages

N88#59 c
N88#60 c
M88#52 b
M88#56 a
M88#57 b
M88#58 b
N87#51 d
N87#52 c
N86#53 a
N86#54 d
N86#55 b
M86#47 b
M86#48 d
M86#49 b
N85#55 d
N85#56 a

M85#55 b
M85#56 a
M85#57 d

**C. Fire and Casualty
Insurance**

M88#59 b
M88#60 a
N87#58 d
N87#59 d
N87#60 d
N86#59 d
N86#60 c
N85#60 b
M85#59 d
M85#60 b

ESSAYS — SELECTED QUESTIONS

I. The CPA and the Law

N88

Number 5 (Estimated time — 15 to 20 minutes)

In order to expand its operations, Dark Corp. raised \$4 million by making a private interstate offering of \$2 million in common stock and negotiating a \$2 million loan from Safe Bank. The common stock was properly offered pursuant to Rule 505 of Regulation D.

In connection with this financing, Dark engaged Crea & Co., CPAs, to audit Dark's financial statements. Crea knew that the sole purpose for the audit was so that Dark would have audited financial statements to provide to Safe and the purchasers of the common stock. Although Crea conducted the audit in conformity with its audit program, Crea failed to detect material acts of embezzlement committed by Dark's president. Crea did not detect the embezzlement because of its inadvertent failure to exercise due care in designing its audit program for this engagement.

After completing the audit, Crea rendered an unqualified opinion on Dark's financial statements. The financial statements were relied upon by the purchasers of the common stock in deciding to purchase the shares. In addition, Safe approved the loan to Dark based on the audited financial statements.

Within 60 days after the sale of the common stock and the making of the loan by Safe, Dark was involuntarily petitioned into bankruptcy. Because of the president's embezzlement, Dark became insolvent and defaulted on its loan to Safe. Its common stock became virtually worthless. Actions have been commenced against Crea by:

- The purchasers of the common stock who have asserted that Crea is liable for damages under Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934.
- Safe, based upon Crea's negligence.

Required: In separate paragraphs, discuss the merits of the actions commenced against Crea, indicating the likely outcomes and the reasons therefor.

M88

Number 5 (Estimated time — 15 to 20 minutes)

Birk Corp. is interested in acquiring Apple & Co. Birk engaged Kaye & Co., CPAs, to audit the 1987 financial statements of Apple. Both Birk and Apple are engaged in the business of providing management consulting services. While reviewing certain contracts entered into by Apple, Kaye became concerned with the proper reporting of the following matters:

- On December 5, 1987, Apple entered into an oral agreement with Cream Inc., to perform certain management advisory services for Cream for a fee of \$150,000 per month. The services were to have commenced on February 15, 1988, and to have ended on December 20, 1988. Apple reported all of the revenues related to the contract on its 1987 financial statements. This constituted 30% of Apple's income for 1987.
- On February 8, 1987, Apple purchased the assets of Nestar & Co., a small management consulting firm. Apple and Nestar entered into a written agreement with regard to the transaction that required Apple to pay Nestar \$80,000 a year for five years. The agreement required Nestar to transfer all of its assets and goodwill to Apple. Further, the agreement required Nestar not to compete with Apple or Apple's successors for a period of three years within the city where the majority of Nestar's clients were located. Nestar's office was also located in this city. Other Nestar clients were located throughout the state.

On February 1, 1988, Birk acquired all of Apple's outstanding stock. Birk's decision was based on the unqualified opinion issued by Kaye on Apple's 1987 financial statements. Within 10 days after the merger, Cream decided not to honor the agreement with Apple and gave notice that it had selected another management consulting firm. This caused the market value of the Apple stock acquired by Birk to decrease drastically.

On May 2, 1987, Birk learned that Nestar opened a management consulting firm three blocks from where Nestar's office had been located on February 8, 1987.

Based on the foregoing, Birk has commenced an action against Kaye alleging negligence in performing the audit of Apple's financial statements.

Required: Answer the following, setting forth reasons for any conclusions stated.

- a. Discuss whether the December 5, 1987, agreement between Cream and Apple is enforceable.
- b. Discuss whether the agreement of Nestar not to compete with Apple is enforceable against Nestar.
- c. Discuss whether Birk will prevail in its action against Kaye & Co., CPAs.

M87

Number 3 (Estimated time — — 15 to 20 minutes)

Dill Corp. was one of three major suppliers who sold raw materials to Fogg & Co. on credit. Dill became concerned over Fogg's ability to pay its debts. Payments had been consistently late and some checks had been returned, marked "insufficient funds". In addition, there were rumors concerning Fogg's solvency. Dill decided it would make no further sales to Fogg on credit unless it received a copy of Fogg's current, audited financial statements. It also required Fogg to assign its accounts receivable to Dill to provide security for the sales to Fogg on credit.

Clark & Wall, CPAs, was engaged by Fogg to perform an examination of Fogg's financial statements upon which they subsequently issued an unqualified opinion. Several months later, Fogg defaulted on its obligations to Dill. At this point Dill was owed \$240,000 by Fogg. Subsequently, Dill discovered that only \$60,000 of the accounts receivable that Fogg had assigned to Dill as collateral was collectible.

Dill has commenced a lawsuit against Clark & Wall. The complaint alleges that Dill has incurred a \$180,000 loss as a result of negligent or fraudulent misrepresentations contained in the audited financial statements of Fogg. Specifically, it alleges negligence, gross negligence, and actual and/or constructive fraud on the part of Clark & Wall in the conduct of the audit and the issuance of an unqualified opinion.

State law applicable to this action follows the majority rule with respect to the accountant's liability to third parties for negligence. In addition, there is no applicable state statute which creates an accountant-client privilege. Dill demanded to be provided a copy of the Fogg workpapers from Clark & Wall who refused to comply with the request claiming that they are privileged documents. Clark & Wall has asserted that the entire action should be dismissed because Dill has no standing to sue the firm because of the absence of any contractual relationship with it, i.e., a lack of privity.

Required: Answer the following, setting forth reasons for any conclusions stated.

- a. Will Clark & Wall be able to avoid production of the Fogg workpapers based upon the assertion that they represent privileged communications?
- b. What elements must be established by Dill to show negligence on the part of Clark & Wall?
- c. What is the significance of compliance with GAAS in determining whether the audit was performed negligently?
- d. What elements must be established by Dill to show actual or constructive fraud on the part of Clark & Wall?

M86

Number 2 (Estimated time — — 15 to 20 minutes)

Tyler Corp. is insolvent. It has defaulted on the payment of its debts and does not have assets sufficient to satisfy its unsecured creditors. Slade, a supplier of raw materials, is Tyler's largest unsecured creditor and is suing Tyler's auditors, Field & Co., CPAs. Slade had extended \$2 million of credit to Tyler based on the strength of Tyler's audited financial statements. Slade's complaint alleges that the auditors were either (1) negligent in failing to discover and disclose fictitious accounts receivable created by management or (2) committed fraud in connection therewith. Field believes that the financial statements of Tyler were prepared in accordance with GAAP and, therefore, its opinion was proper. Slade has established that:

- The accounts receivable were overstated by \$10 million.
- Total assets were reported as \$24 million of which accounts receivable were \$16 million.
- The auditors did not follow their own audit program which required that confirmation requests be sent to an audit sample representing 80% of the total dollar amount of outstanding receivables. Confirmation requests were sent to only 45%.
- The responses which were received represented only 20% of the total dollar amount of outstanding receivables. This was the poorest response in the history of the firm, the next lowest being 60%. The manager in charge of the engagement concluded that further inquiry was necessary. This recommendation was rejected by the partner in charge.
- Field had determined that a \$300,000 account receivable from Dion Corp. was non-existent. Tyler's explanation was that Dion had reneged on a purchase contract before any products had been shipped. At Field's request Tyler made a reversing entry to eliminate this overstatement. However, Field accepted Tyler's explanation as to this and several similar discrepancies without further inquiry.

Selected Questions

Slade asserts that Field is liable:

- As a result of negligence in conducting the audit.
- As a result of fraud in conducting the audit.

Required: Answer the following, setting forth reasons for any conclusions stated.

Discuss Slade's assertions and the defenses which might be raised by Field.

N85

Number 2 (Estimated time — 15 to 20 minutes)

Mason & Dilworth, CPAs, were the accountants for Monrad Corporation, a closely held corporation. Mason & Dilworth had been previously engaged by Monrad to perform certain compilation and tax return work. Crass, Monrad's president, indicated he needed something more than the previous type of services rendered. He advised Walker, the partner in charge, that the financial statements would be used internally, primarily for management purposes, and also to obtain short-term loans from financial institutions. Walker recommended that a review of the financial statements be performed. Walker did not prepare an engagement letter.

In the course of the review, Walker indicated some reservations about the financial statements. Walker indicated at various stages that "he was uneasy about certain figures and conclusions" but that "he would take the client's word about the validity of certain entries since the review was primarily for internal use in any event and was not an audit."

Mason & Dilworth did not discover a material act of fraud committed by management. The fraud would have been detected had Walker not relied wholly on the representations of management concerning the validity of certain entries about which he had felt uneasy.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. What is the role of the engagement letter when a CPA has agreed to perform a review of a closely held company? What points should be covered in a typical engagement letter which would be relevant to the parties under the facts set forth above?

b. What is the duty of the CPA in the event suspicious circumstances are revealed as a result of the review?

c. What potential liability does Mason & Dilworth face and who may assert claims against the firm?

M85

Number 4 (Estimated time — 15 to 20 minutes)

Arthur & Doyle, CPAs, served as auditors for Dunbar Corp. and Wolfe Corp., publicly held corporations listed on the American Stock Exchange. Dunbar recently acquired Wolfe Corp. pursuant to a statutory merger by issuing its shares in exchange for shares of Wolfe. In connection with that merger, Arthur & Doyle rendered an unqualified opinion on the financial statements and participated in the preparation of the pro forma unaudited financial statements contained in the combined prospectus and proxy statement circulated to obtain shareholder approval of the merger and to register the shares to be issued in connection with the merger. Dunbar prepared a form 8-K (the current report with unaudited financial statements) and form 10-K (the annual report with audited financial statements) in connection with the merger. Shortly thereafter, financial disaster beset the merged company which resulted in large losses to the shareholders and creditors. A class action suit on behalf of the shareholders and creditors has been filed against Dunbar and its management. In addition, it names Arthur & Doyle as co-defendants, challenging the fairness, accuracy, and truthfulness of the financial statements.

Required: Answer the following, setting forth reasons for any conclusions stated.

As a result of the CPAs having expressed an unqualified opinion on the audited financial statements of Dunbar and Wolfe and as a result of having participated in the preparation of the unaudited financial statements required in connection with the merger, indicate and briefly discuss the various bases of the CPAs' potential civil liability to the shareholders and creditors of Dunbar under:

- a. The federal securities acts.
- b. State common law.

II. Business Organizations

B. Partnerships and Joint Ventures

N88

Number 4 (Estimated time — 15 to 20 minutes)

On January 5, Stein, Rey, and Lusk entered into a written general partnership agreement by which they agreed to operate a stock brokerage firm. The agreement stated that the partnership would continue upon the death or withdrawal of a partner. The agreement also provided that no partner could reduce the firm's commission below 2% without the consent of all of the other partners. On March 10, Rey, without the consent of Stein and Lusk, agreed with King Corp. to reduce the commission to 1½% on a large transaction by King. Rey believed this would entice King to become a regular customer of the firm. King was unaware of any of the terms of the partnership agreement.

On May 15, Stein entered into a contract conveying Stein's partnership interest to Park and withdrew from the partnership. That same day, all of the partners agreed to admit Park as a general partner. Notice of Stein's withdrawal and Park's admission as a partner was properly published in two newspapers. In addition, third parties who had conducted business with the partnership prior to May 15 received written notice of Stein's withdrawal.

Required:

a. In separate paragraphs, discuss whether:

1. The partnership could recover the ½% commission from King.

2. The partnership could recover the ½% commission from Rey.

b. In separate paragraphs, discuss:

1. Park's liability for partnership obligations arising both before and after being admitted to the partnership.

2. Stein's liability for partnership obligations arising both before and after withdrawing from the partnership.

M88

Number 3 (Estimated time — 15 to 20 minutes)

Walsh is evaluating two different investment opportunities. One requires an investment of \$100,000 to become a limited partner in a limited partnership that owns a shopping center. The other requires an investment of \$100,000 to purchase 3% of the voting common stock of a corporation engaged in manufacturing. Walsh is uncertain about the advantages and disadvantages of being a limited partner versus being a shareholder. The issues of most concern to Walsh are:

- The right to transfer a limited partnership interest versus shares of stock.

- The liability as a limited partner versus that of a shareholder for debts incurred by a limited partnership or a corporation.
- The right of a limited partner versus that of a shareholder to participate in daily management.
- The right of a limited partner to receive partnership profits versus the right of a shareholder to receive dividends from a corporation.

Required: Briefly identify and discuss the basic differences and similarities in the formation of a limited partnership and a corporation. Discuss in separate paragraphs the issues raised by Walsh. (Ignore tax and securities laws.)

N86

Number 2 (Estimated time — 15 to 20 minutes)

Edna Slavin intends to enter into a limited partnership with three of her business associates. Slavin wishes to know the advantages and disadvantages of being a general partner as opposed to a limited partner in a limited partnership. The issues of most concern to Slavin are:

- Her right as a general or limited partner to participate in the daily management of the partnership.
- Her liability as a general or limited partner for debts incurred on behalf of or by the partnership.
- Her right as a general or limited partner to assign her partnership interest and substitute a third party as a partner.
- The effect of a clause in the certificate of limited partnership which would permit the partnership to continue after the death of one of the general or limited partners.

Required: Answer the following, setting forth reasons for any conclusions stated.

What are the essential differences in the formation of a general partnership and a limited partnership? Discuss in separate paragraphs the issues raised by Slavin.

N85

Number 3 (Estimated time — 15 to 20 minutes)

John Nolan, a partner in Nolan, Stein, & Wolf partnership, transferred his interest in the partnership to Simon and withdrew from the partnership. Although the partnership will continue, Stein and Wolf have refused to admit Simon as a partner.

Subsequently, the partnership appointed Ed Lemon as its agent to market its various product lines.

Selected Questions

Lemon entered into a two-year written agency contract with the partnership which provided that Lemon would receive a 10% sales commission. The agency contract was signed by Lemon and, on behalf of the partnership, by Stein and Wolf.

After six months, Lemon was terminated without cause. Lemon asserts that:

- He is an agent coupled with an interest.
- The agency relationship may not be terminated without cause prior to the expiration of its term.
- He is entitled to damages because of the termination of the agency relationship.

Required: Answer the following, setting forth reasons for any conclusions stated.

- a. Discuss Nolan's property rights in the partnership prior to his withdrawal and the property rights acquired by Simon as a result of his transaction with Nolan.
- b. Discuss the merits of Lemon's assertions.

C. Corporations

M89

Number 4 (Estimated time — — 15 to 20 minutes)

On May 1, 1987, Cray's board of directors unanimously voted to have Cray reacquire 100,000 shares of its common stock. On May 25, 1987, Cray did so, paying current market price. In determining whether to reacquire the shares, the board of directors relied on reports and financial statements that were negligently prepared by Cray's internal accounting department under the supervision of the treasurer and reviewed by its independent accountants. The reports and financial statements indicated that, as of April 30, 1987, Cray was solvent and there were sufficient funds to reacquire the shares. Subsequently, it was discovered that Cray had become insolvent in March 1987 and continued to be insolvent after the reacquisition of the shares. As a result of the foregoing, Cray experienced liquidity problems and losses during 1987 and 1988.

The board of directors immediately fired the treasurer because of the treasurer's negligence in supervising the preparation of the reports and financial statements. The treasurer had three years remaining on a binding five-year employment agreement which, among other things, prohibited the termination of the treasurer's employment for mere negligence.

Required: Discuss the following assertions, indicating whether such assertions are correct and the reasons therefor.

- It was improper for the board of directors to authorize the reacquisition of Cray's common stock while Cray was insolvent.

- The members of the board of directors are personally liable because they voted to reacquire shares while Cray was insolvent.
- Cray will be liable to the treasurer as a result of his termination by the board of directors.

N88

Number 3 (Estimated time — — 15 to 20 minutes)

Maple owns 75% of the common stock of Salam Exterminating, Inc. Maple is not an officer or employee of the corporation, and does not serve on its board of directors. Salam is in the business of providing exterminating services to residential and commercial customers.

Dodd performed exterminating services on behalf of Salam. Dodd suffered permanent injuries as a result of inhaling one of the chemicals used by Salam. This occurred after Dodd sprayed the chemical in a restaurant that Salam regularly services. Dodd was under the supervision of one of Salam's district managers and was trained by Salam to perform exterminating services following certain procedures, which he did. Later that day several patrons who ate at the restaurant also suffered permanent injuries as a result of inhaling the chemical. The chemical was manufactured by Ace Chemical Corp. and sold and delivered to Salam in a closed container. It was not altered by Salam. It has now been determined that the chemical was defectively manufactured and the injuries suffered by Dodd and the restaurant patrons were a direct result of the defect.

Salam has complied with an applicable compulsory workers' compensation statute by obtaining an insurance policy from Spear Insurance Co.

As a result of the foregoing, the following actions have been commenced:

- Dodd sued Spear to recover workers' compensation benefits.
- Dodd sued Salam based on negligence in training him.
- Dodd sued Ace based on strict liability in tort.
- The restaurant patrons sued Maple claiming negligence in not preventing Salam from using the chemical purchased from Ace.

Required: Discuss the merits of the actions commenced by Dodd and the restaurant patrons, indicating the likely outcomes and your reasons therefor.

M88

Number 3 (Estimated time — — 15 to 20 minutes)

Walsh is evaluating two different investment opportunities. One requires an investment of \$100,000 to become a limited partner in a limited partnership that owns a shopping center. The other requires an invest-

Business Law

ment of \$100,000 to purchase 3% of the voting common stock of a corporation engaged in manufacturing. Walsh is uncertain about the advantages and disadvantages of being a limited partner versus being a shareholder. The issues of most concern to Walsh are:

- The right to transfer a limited partnership interest versus shares of stock.
- The liability as a limited partner versus that of a shareholder for debts incurred by a limited partnership or a corporation.
- The right of a limited partner versus that of a shareholder to participate in daily management.
- The right of a limited partner to receive partnership profits versus the right of a shareholder to receive dividends from a corporation.

Required: Briefly identify and discuss the basic differences and similarities in the formation of a limited partnership and a corporation. Discuss in separate paragraphs the issues raised by Walsh. (Ignore tax and securities laws.)

N87

Number 5 (Estimated time — — 15 to 20 minutes)

Mace, Inc., wishes to acquire Creme Corp., a highly profitable company with substantial retained earnings. Creme is incorporated in a state that recognizes the concepts of stated capital (legal capital) and capital surplus.

In conjunction with the proposed acquisition, Mace engaged Gold & Co., CPAs, to audit Creme's financial statements. Gold began analyzing Creme's stated capital account and was provided the following data:

- Creme was initially capitalized in 1980 by issuing 40,000 shares of common stock, 50¢ par value, at \$15 per share. The total number of authorized shares was fixed at 100,000 shares.
- Costs to organize Creme were \$15,000.
- During 1982, Creme's board of directors declared and distributed a 5% common stock dividend. The fair market value of the stock at that time was \$20 per share.
- On June 1, 1983, the president of Creme exercised a stock option to purchase 1,000 shares of common stock at \$21 per share when the market price was \$25 per share.
- During 1984, Creme's board of directors declared and distributed a 2-for-1 stock split on its common stock when the market price was \$28 per share.
- During 1985, Creme acquired as treasury stock 5,000 shares of its common stock at a market price of \$30 per share. Creme uses the cost method of accounting and reporting for treasury stock.
- During 1986, Creme reissued 3,000 shares of the treasury stock at the market price of \$32 per share.

Required: Answer the following, setting forth reasons for any conclusions stated.

- a. Discuss what effect each of the transactions described above would have on stated capital (legal capital), indicating the dollar amount of change.
- b. Discuss the requirements necessary to properly declare and pay cash dividends.

N86

Number 4 (Estimated time — — 15 to 20 minutes)

Jane Mead, a 7% minority shareholder in Sky Corp. for several years, is unhappy with the way Ed Rice, the president of Sky, has been operating Sky. The Board of Directors of Sky has refused to pursue any of the actions requested by Mead. In addition, Sky is contemplating a proposed merger with King Corp., a conglomerate into which Sky would be merged.

As a result of the foregoing, Mead asserts that she personally has the right to:

- Examine the books, records, and shareholder list of Sky.
- Have Rice removed as president of Sky.
- Obtain payment for her shares in Sky in the event the proposed merger is consummated.

Rice refuses to give Mead access to Sky's books, records, and shareholder list and asserts the following:

- That the refusal to permit Mead access to Sky's books, records, and shareholder list is based upon Mead's attempt to sell the shareholder list 13 months ago.
- That he cannot be removed as president of Sky since he has a three-year written contract with two years remaining, and that such removal can only be made for cause by a majority vote of the shareholders at its annual meeting.
- That Mead would not be entitled to payment in the event the merger is consummated since the Articles of Incorporation are silent on this point.

Required: Answer the following, setting forth reasons for any conclusions stated.

- a. Discuss the assertions of Mead and Rice with regard to Mead's right to inspect Sky's books, records, and shareholder list.
- b. Discuss the assertions of Mead and Rice with regard to whether Rice may be removed as the president of Sky.
- c. Discuss the assertions of Mead and Rice with regard to whether Mead is entitled to payment for her shares in the event the merger is consummated.

Selected Questions

M86

Number 4 (Estimated time — 15 to 20 minutes)

Major formed the Dix Corp. for the purpose of operating a business to repair, install, and sell used refrigerators. Major is the sole shareholder and president of Dix. Major owns 2,000 shares of \$10 par value common stock. He paid for 1,000 of these shares by transferring to Dix property with a fair market value of \$3,500 and his promissory note for \$2,500 due and payable on June 1, 1988. He also received at a later date 1,000 shares in consideration of services rendered to Dix fairly valued at \$7,000 and his agreement to render specific additional services starting with January 1, 1987, which are fairly valued at \$1,000. The promissory note has not been paid nor have the additional services been rendered.

Fox, a customer of Dix, was seriously injured when a refrigerator negligently repaired by Major on behalf of Dix caught fire. Dix has \$500,000 of liability insurance covering itself and its employees for such occurrences. Fox wishes to hold Major personally liable since Dix has insufficient assets and insurance to pay Fox's claim.

Pine, one of Dix's largest creditors, has asserted claims against Major, individually, claiming that Major is:

- Personally liable to the extent of \$6,000 for the common shares issued to him.
- Personally liable for all of the debts of Dix because he instructed several of Dix's customers to make checks payable to the order of Major which were deposited in his individual account and not recorded on the corporate books.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss Major's liability and the liability of Dix for the injuries sustained by Fox. What effect does the insurance carried by Dix have on Major's and Dix's liability to Fox?

b. Discuss the assertions of Pine and reach a conclusion for each.

D. Estates and Trusts

M87

Number 5 (Estimated time — 15 to 20 minutes)

John Reed, a wealthy businessman, established an inter vivos trust on January 1, 1986, to provide for the financial needs of his son and wife. The written trust agreement signed by Reed provided for income to his wife, Myrna, for her life with the remainder to his son, Rodney. Reed named Mini Bank as the sole trustee and transferred stocks, bonds, and two commercial buildings to the trust. The accounting period selected for the trust was the calendar year.

During the first year of the trust's existence, Mini made the following allocations to principal and income arising out of transactions involving the trust property:

- With regard to the sale of \$25,000 of stock, \$20,000 to income representing the gain on the sale of stock and \$5,000 to principal representing the cost basis of the stock.
- \$95,000 to income from rental receipts earned and received after the trust was created.
- \$6,000 to income and \$2,000 to principal as a result of a stock dividend of 400 shares of \$5 par value common stock at a time when the stock was selling for \$20 per share.
- \$10,000 to income for bond interest received and which is payable semi-annually on April 1 and October 1.
- \$35,000 to principal as a result of mortgage payments made by the trust on the commercial buildings.

The instrument creating the trust is silent as to the allocation of the trust receipts and disbursements to principal and income.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Have the requirements been met for the creation of a valid inter vivos trust?

b. Indicate the proper allocation to principal and income of the trust receipts and disbursements described above under the majority rules, ignoring the tax effect of each transaction.

III. Contracts

N88

Number 2 (Estimated time — 15 to 20 minutes)

Dunn & Co., CPAs, while performing the 1987 year-end audit of Starr Corp.'s financial statements discovered that certain events during 1987 had resulted in litigation.

Starr had purchased the warehouse on March 1, 1987. The contract between Birk and Starr provided for a closing on September 20, 1987. On July 1, 1987, Birk executed a contract to purchase the warehouse from Starr for \$200,000. On September 1, 1987, Birk contacted Starr and demanded that the purchase price be reduced to \$190,000 because of a sudden rise in interest rates and declining value of real estate. Starr orally agreed to change the price to \$190,000. On September 2, Birk sent Starr a signed memo confirming the reduction in price to \$190,000. Starr did not sign the memo or any other agreement reducing the price. On September 15, Starr, by telephone, informed Birk that it would not sell the warehouse for \$190,000. Birk refused to pay Starr \$200,000 and a closing never occurred.

On October 30, 1987, a fire caused \$80,000 damage to the warehouse at a time when its fair market value was \$200,000. Starr had obtained a \$160,000 fire insurance policy on February 15, 1987, from Pica Casualty Co., covering the warehouse. On April 11, 1987, Starr obtained another fire insurance policy from Drake Insurance Co. covering the warehouse for \$40,000. Each policy contained an 80% coinsurance clause and a provision limiting each company's liability to its proportion of all insurance covering the loss. Pica has refused to pay any amount on its policy.

Starr commenced actions against Birk and Pica asserting the following:

- Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of \$200,000.
- Starr has an insurable interest in the warehouse covered under the policy with Pica.
- Starr has met the coinsurance requirement under Pica's policy.
- Starr is entitled to recover the entire \$80,000 from Pica.

Required: Discuss Starr's assertions, indicating whether such assertions are correct and the reasons therefor.

M88

Number 5 (Estimated time — 15 to 20 minutes)

Birk Corp. is interested in acquiring Apple & Co. Birk engaged Kaye & Co., CPAs, to audit the 1987 financial statements of Apple. Both Birk and Apple are

engaged in the business of providing management consulting services. While reviewing certain contracts entered into by Apple, Kaye became concerned with the proper reporting of the following matters:

- On December 5, 1987, Apple entered into an oral agreement with Cream Inc., to perform certain management advisory services for Cream for a fee of \$150,000 per month. The services were to have commenced on February 15, 1988 and to have ended on December 20, 1988. Apple reported all of the revenues related to the contract on its 1987 financial statements. This constituted 30% of Apple's income for 1987.
- On February 8, 1987, Apple purchased the assets of Nestar & Co., a small management consulting firm. Apple and Nestar entered into a written agreement with regard to the transaction that required Apple to pay Nestar \$80,000 a year for five years. The agreement required Nestar to transfer all of its assets and goodwill to Apple. Further, the agreement required Nestar not to compete with Apple or Apple's successors for a period of three years within the city where the majority of Nestar's clients were located. Nestar's office was also located in this city. Other Nestar clients were located throughout the state.

On February 1, 1988, Birk acquired all of Apple's outstanding stock. Birk's decision was based on the unqualified opinion issued by Kaye on Apple's 1987 financial statements. Within 10 days after the merger, Cream decided not to honor the agreement with Apple and gave notice that it had selected another management consulting firm. This caused the market value of the Apple stock acquired by Birk to decrease drastically.

On May 2, 1987, Birk learned that Nestar opened a management consulting firm three blocks from where Nestar's office had been located on February 8, 1987.

Based on the foregoing, Birk has commenced an action against Kaye alleging negligence in performing the audit of Apple's financial statements.

Required: Answer the following, setting forth reasons for any conclusions stated.

- a. Discuss whether the December 5, 1987, agreement between Cream and Apple is enforceable.
- b. Discuss whether the agreement of Nestar not to compete with Apple is enforceable against Nestar.
- c. Discuss whether Birk will prevail in its action against Kaye & Co., CPAs.

Selected Questions

N87

Number 4 (Estimated time — 15 to 20 minutes)

On April 1, Sam Stieb signed and mailed to Bold Corp. an offer to sell Bold a parcel of land for \$175,000. On April 5, Bold called Stieb and requested that Stieb keep the offer open until June 1, by which time Bold would be able to determine whether financing for the purchase was available. That same day, Stieb signed and mailed a letter indicating that he would hold the offer open until June 1 if Bold mailed Stieb \$100 by April 20.

On April 17, Stieb sent Bold a signed letter revoking his offers dated April 1 and April 5. Bold received that letter on April 19. However, Bold had already signed and mailed on April 18 its acceptance of Stieb's offer of April 5 along with a check for \$100. Stieb received the check and letter of acceptance on April 20.

On May 15, Bold wrote Stieb stating that the \$175,000 purchase price was too high but that it would be willing to purchase the land for \$160,000. Upon receipt, Stieb immediately sent a telegram to Bold indicating that he had already revoked his offer and that even if his revocation was not effective, he considered Bold's offer a counteroffer which he would not accept.

Otherwise, Stieb did nothing as a result of Bold's May 15 letter.

On May 25, Bold executed and delivered the original contract of April 1 to Stieb without any variation of the original terms.

Stieb does not wish to sell the land to Bold because he has received another offer for \$200,000. In order to avoid the sale to Bold for \$175,000, Stieb asserts the following:

- Bold could not validly accept Stieb's offer dated April 5 because \$100 was inadequate consideration to hold the offer open until April 20.
- Stieb's offer dated April 5 had terminated because he had revoked the offer prior to Bold's acceptance.
- Even if his revocation was not effective, Bold's letter of May 15 was a counteroffer, which automatically terminated Bold's right to accept Stieb's offer of April 1.

Required: Discuss Stieb's assertions, indicating whether such assertions are correct or incorrect and setting forth the reasons for any conclusions stated.

IV. Debtor-Creditor Relationships

B. Bankruptcy

M89

Number 2 (Estimated time — 15 to 20 minutes)

On March 23, 1989, Tine, a sole proprietor, was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code. The petition was filed by Lux, Squire, and Rusk, who were creditors of Tine with unsecured claims of \$3,000, \$4,000, and \$2,000, respectively. Tine also has 10 other unsecured creditors, three partially secured creditors, and two fully secured creditors, none of whom joined in the filing of the bankruptcy petition. For the six-month period before the filing of the bankruptcy petition, Tine had been unable to pay current obligations as they became due. At the time the petition was filed, Tine had a negative net worth.

Before March 23, 1989, Tine entered into the following transactions:

- On December 29, 1988, Tine borrowed \$250,000 from Safe Finance. On January 31, 1989, after learning of Tine's financial problems, Safe requested that Tine execute a mortgage on Tine's residence naming Safe as mortgagee. On January 31, 1989, Tine executed the mortgage and delivered it to Safe and it was recorded that same day. The residence had a fair market value of \$300,000 at all times.

- On May 5, 1988, Rich Bank loaned Tine \$50,000 based on Tine's personal financial statements. Tine knew the financial statements submitted to Rich substantially overstated Tine's net worth because of misrepresentations that were difficult to detect.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss whether the requirements necessary for the commencement of an involuntary bankruptcy proceeding were met.

b. Assuming that the requirements necessary for the commencement of an involuntary bankruptcy were met, discuss the following:

1. What action may the court take regarding the transactions between Tine and Safe?
2. What action may the court take regarding the transaction between Tine and Rich if Rich challenges the discharge of its debt?

N87

Number 3 (Estimated time — 15 to 20 minutes)

On July 1, 1986, Mix was petitioned by Able into bankruptcy under the liquidation provisions of the Bankruptcy Code. Able and Baker are unsecured creditors of Mix, owed \$20,000 and \$40,000 respectively. Mix also owes Carr \$80,000, secured by a valid per-

Business Law

affected security interest in bankruptcy on Mix's machinery, valued at \$20,000. Mix has no other debts, except for 1986 federal income taxes.

Shortly after the filing of the petition Lang was appointed trustee in Mix's bankruptcy. In Lang's capacity as trustee, Lang:

- Engaged Ring & Co., CPAs, as the accountants for the bankruptcy estate.
- Included as part of the bankruptcy estate, an inheritance that Mix became entitled to receive on December 15, 1986 and that Mix actually received on January 15, 1987.

Lang has sold the property in the estate (including the sale of Mix's machinery for \$20,000, which Carr consented to) and now the sole asset of the estate is \$60,000 cash. Lang wishes to distribute the \$60,000 so as to satisfy the following claims and expenses of the estate:

• Unsecured claim for 1986 federal income taxes	\$6,000
• Carr's claim	80,000
• Able's and Baker's claims	60,000
• Expenses necessary to maintain and sell the unsecured property of the estate	1,000
• Ring's fee for services rendered	3,000

There are no other claims.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Under the facts, were the requirements necessary for the filing of a valid petition in bankruptcy met? Discuss.

b. Discuss whether Lang's actions in engaging Ring and including the inheritance in the bankruptcy estate were proper.

c. Indicate the order in which the \$60,000 should be distributed to satisfy the claims and expenses of the bankruptcy estate, assuming all necessary court approvals have been obtained.

M86

Number 5 (Estimated time — 15 to 20 minutes)

Ed Walsh, a sole proprietor, filed a petition in bankruptcy under the liquidation provisions of Chapter 7 of the Bankruptcy Code. Salam Corp., one of Walsh's largest creditors, wishes to prevent Walsh from receiving a discharge in bankruptcy or in the alternative to have its debt excepted from a discharge. Salam asserts to the trustee in bankruptcy that:

- Walsh neither listed nor scheduled Salam's debt at any time during the bankruptcy proceeding.

- Walsh failed to preserve his financial records which are necessary to ascertain his financial condition.
- Walsh obtained money from Salam by using false financial statements.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss the assertions of Salam, indicating the consequences if such assertions are proven correct.

b. If Walsh obtains a discharge in bankruptcy and certain creditors of Walsh wish to have the discharge revoked, discuss the various bases upon which such revocation may be granted, indicating who may request the revocation and the time within which an action requesting such revocation must be made.

M85

Number 5 (Estimated time — 15 to 20 minutes)

On July 1, Sam Baker, a sole proprietor operating a drugstore, was involuntarily petitioned into bankruptcy by his creditors. At that time, and for at least 60 days prior thereto, Baker was unable to pay his current obligations and also had a negative net worth. Prior to the filing of the petition Baker made the following transfers:

- May 17 — Paid Nix, an unsecured creditor, the full \$7,500 outstanding on a loan obtained from Nix on April 10.
- June 6 — Gave Mary Wax a mortgage on his home for a loan which Wax made to Baker on June 4 which they intended to be a secured loan.
- June 16 — Paid the electric bill for the month of May which was incurred in Baker's business. The bill was received by Baker on June 4 and had a June 18 due date.

At the time the petition was filed, Baker owned a rental warehouse and was involved in a divorce proceeding. The trustee in bankruptcy has informed Baker that the debtor's (Baker's) estate will include the following nonexempt property:

- Rents received from July 1 through November 1 on the warehouse.
- Property received on October 10 as a result of the Bakers' final divorce decree.

Required: Answer the following, setting forth reasons for any conclusions stated.

In separate paragraphs, discuss whether the trustee in bankruptcy can properly avoid or set aside the three transfers made by Baker? Was the trustee correct by including in the debtor's estate rents on the warehouse and the property received as a result of the final divorce decree?

Selected Questions

V. Government Regulation of Business

A. Regulation of Employment

N88

Number 3 (Estimated time — 15 to 20 minutes)

Maple owns 75% of the common stock of Salam Exterminating, Inc. Maple is not an officer or employee of the corporation, and does not serve on its board of directors. Salam is in the business of providing exterminating services to residential and commercial customers.

Dodd performed exterminating services on behalf of Salam. Dodd suffered permanent injuries as a result of inhaling one of the chemicals used by Salam. This occurred after Dodd sprayed the chemical in a restaurant that Salam regularly services. Dodd was under the supervision of one of Salam's district managers and was trained by Salam to perform exterminating services following certain procedures, which he did. Later that day several patrons who ate at the restaurant also suffered permanent injuries as a result of inhaling the chemical. The chemical was manufactured by Ace Chemical Corp. and sold and delivered to Salam in a closed container. It was not altered by Salam. It has now been determined that the chemical was defectively manufactured and the injuries suffered by Dodd and the restaurant patrons were a direct result of the defect.

Salam has complied with an applicable compulsory workers' compensation statute by obtaining an insurance policy from Spear Insurance Co.

As a result of the foregoing, the following actions have been commenced:

- Dodd sued Spear to recover workers' compensation benefits.
- Dodd sued Salam based on negligence in training him.
- Dodd sued Ace based on strict liability in tort.
- The restaurant patrons sued Maple claiming negligence in not preventing Salam from using the chemical purchased from Ace.

Required: Discuss the merits of the actions commenced by Dodd and the restaurant patrons, indicating the likely outcomes and your reasons therefor.

B. Federal Securities Acts

N85

Number 5 (Estimated time — 15 to 20 minutes)

One of your firm's clients, Fancy Fashions, Inc., is a highly successful, rapidly expanding company. The company is owned predominantly by the Munn family and key corporate officers. Although additional funds would be available on a short-term basis from its bankers, this would only represent a short-term solution to the company's need for capital to fund its expansion plans. In addition, the interest rates being charged are not appealing. Therefore, John Munn, Fancy's chairman of the board, in consultation with the other shareholders, has decided to explore raising additional equity capital of approximately \$4.5 to \$5 million which will provide the funds necessary to continue the growth and expansion of the company. This will be Fancy's first offering to persons other than the Munn family and key management personnel.

At a meeting of Fancy's major shareholders, its attorneys and a CPA from your firm, the advantages and disadvantages of "going public" and registering an offering of its stock were discussed. One of the participants suggested that Regulation D under the Securities Act of 1933 might be a preferable alternative.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. What are the elements or factors which will determine whether Fancy's offering is required to be registered pursuant to the provisions of the Securities Act of 1933?

b. Assume there is a public offering for \$4.5 million and, as a result, more than 500 persons own shares of Fancy. What implications, if any, will these facts have in respect to the Securities Exchange Act of 1934?

c. What federal civil and criminal liabilities may apply in the event that Fancy sells the securities without a registration and an exemption to registration is not available?

d. Discuss the exemption applicable to offerings of up to \$5 million (under Rule 505 of Regulation D) in terms of:

1. What are the two kinds of and the number of investors who may participate?
2. Are audited financial statements required?
3. What restrictions apply to the manner or way the securities may be sold?

VI. Uniform Commercial Code

A. Commercial Paper

M87

Number 2 (Estimated time — 15 to 20 minutes)

Prince, Hall, & Charming, CPAs, has been retained to examine the financial statements of Hex Manufacturing Corporation. Shortly before beginning the examination for the year ended December 31, 1986, Mr. Prince received a telephone call from Hex's president indicating that he thought some type of embezzlement was occurring because the corporation's cash position was significantly lower than in prior years. The president then requested that Prince immediately undertake a special investigation to determine the amount of embezzlement, if any.

After a month of investigation, Prince uncovered an embezzlement scheme involving collusion between the head of payroll and the assistant treasurer. The following is a summary of Prince's findings:

- The head of payroll supplied the assistant treasurer with punched time cards for fictitious employees. The assistant treasurer prepared invoices, receiving reports, and purchase orders for fictitious suppliers. The assistant treasurer prepared checks for the fictitious employees and suppliers which were signed by the treasurer. Then, either the assistant treasurer or the head of payroll would endorse the checks and deposit them in various banks where they maintained accounts in the names of the fictitious payees. All of the checks in question have cleared Omega Bank, the drawee.
- The embezzlement scheme had been operating for 10 months and more than \$120,000 had been embezzled by the time the scheme was uncovered. The final series of defalcations included checks payable directly to the head of payroll and the assistant treasurer. These checks included skillful forgeries of the treasurer's signature that were almost impossible to detect. This occurred while the treasurer was on vacation. These checks have also cleared Omega Bank, the drawee.

Required: Answer the following, setting forth reasons for any conclusions stated.

Will Hex or Omega bear the loss with respect to the following categories of checks:

- a. those which were signed by the treasurer but payable to fictitious payees?
- b. those which include the forged signature of the treasurer?

C. Sales

M89

Number 5 (Estimated time — 15 to 20 minutes)

On February 20, 1989, Pine, Inc. ordered a specially manufactured computer system consisting of a disk drive and a central processing unit (CPU) from Xeon Corp., a seller of computers and other office equipment. A contract was signed and the total purchase price was paid to Xeon by Pine on the same date. The contract required Pine to pick up the computer system at Xeon's warehouse on March 9, 1989, but was silent as to when risk of loss passed to Pine. The computer system was completed on March 1, 1989, and set aside for Pine's contemplated pickup on March 9, 1989. On March 3, 1989, the disk drive was stolen from Xeon's warehouse. On March 9, 1989, Pine picked up the CPU. On March 15, 1989, Pine returned the CPU to Xeon for warranty repairs. On March 18, 1989, Xeon mistakenly sold the CPU to Meed, a buyer in the ordinary course of business.

On April 12, 1989, Pine purchased and received delivery of five word processors from Jensen Electronics Corp. for use in its business. The purchase price of the word processors was \$15,000. Pine paid \$5,000 down and executed an installment purchase note and a security agreement for the balance. The security agreement contained a description of the word processors. Jensen never filed a financing statement. On April 1, 1989, Pine had given its bank a security interest in all of its assets. The bank had immediately perfected its security interest by filing. Pine has defaulted on the installment purchase note.

Required: Discuss the following assertions, indicating whether such assertions are correct and the reasons therefor.

- As of March 3, 1989, the risk of loss on the disk drive remained with Xeon.
- Meed acquired no rights in the CPU as a result of the March 18, 1989, transaction.
- Jensen's security interest in the word processors never attached and therefore Jensen's security interest is not enforceable against Pine.
- Jensen has a superior security interest to Pine's bank.

N88

Number 3 (Estimated time — 15 to 20 minutes)

Maple owns 75% of the common stock of Salam Exterminating, Inc. Maple is not an officer or employee of the corporation, and does not serve on its board of

Selected Questions

directors. Salam is in the business of providing exterminating services to residential and commercial customers.

Dodd performed exterminating services on behalf of Salam. Dodd suffered permanent injuries as a result of inhaling one of the chemicals used by Salam. This occurred after Dodd sprayed the chemical in a restaurant that Salam regularly services. Dodd was under the supervision of one of Salam's district managers and was trained by Salam to perform exterminating services following certain procedures, which he did. Later that day several patrons who ate at the restaurant also suffered permanent injuries as a result of inhaling the chemical. The chemical was manufactured by Ace Chemical Corp. and sold and delivered to Salam in a closed container. It was not altered by Salam. It has now been determined that the chemical was defectively manufactured and the injuries suffered by Dodd and the restaurant patrons were a direct result of the defect.

Salam has complied with an applicable compulsory workers' compensation statute by obtaining an insurance policy from Spear Insurance Co.

As a result of the foregoing, the following actions have been commenced:

- Dodd sued Spear to recover workers' compensation benefits.
- Dodd sued Salam based on negligence in training him.
- Dodd sued Ace based on strict liability in tort.
- The restaurant patrons sued Maple claiming negligence in not preventing Salam from using the chemical purchased from Ace.

Required: Discuss the merits of the actions commenced by Dodd and the restaurant patrons, indicating the likely outcomes and your reasons therefor.

M88

Number 2 (Estimated time — — 15 to 20 minutes)

Mirk & Co., CPAs, has been engaged to audit Spear Corp.'s 1987 financial statements. Spear is engaged in the business of buying and selling computers. Spear has adopted a calendar year for accounting purposes. While conducting the audit, Mirk reviewed the following transactions occurring in December 1987.

- On December 20, Spear sold five computers to Pica Corp. The contract required Spear to ship the computers by common carrier. The shipping terms of the contract were "F.O.B.—Spear's loading dock." The computers were shipped on December 30, and on January 1, 1988, while the computers were in transit, the common carrier was involved in an accident causing a fire that totally destroyed the com-

puters. Pica discovered, upon a review of a copy of the common carrier's bill of lading, that the destroyed computers were not the models it had ordered.

- On December 21, Spear purchased and took delivery of 15 computers from Larson for \$20,000. Larson had purchased the computers from Xeon Co., paying Xeon with a check that Larson's bank refused to honor because of insufficient funds. Spear was unaware that Larson's check was dishonored.
- On December 22, Spear entered into a sale on approval contract with Rusk Corp. for two computers. Rusk is engaged exclusively in the business of selling furniture. The contract required Rusk to notify Spear within 15 days after delivery if it did not want to keep the computers. Rusk took delivery of the computers on December 21, and, as of December 31, had not yet decided whether to keep the computers.

With regard to the transactions described above, Mirk wishes to resolve the following issues that were not addressed in the specific contracts:

As of December 31, 1987, which of the parties bears the risk of loss for the computers with regard to the:

- December 20 transaction with Pica?
- December 22 transaction with Rusk?

As of December 31, 1987, which of the parties has title to the computers with regard to the:

- December 21 transaction with Larson?
- December 22 transaction with Rusk?

What rights do the general creditors of Rusk have to the computers delivered to Rusk pursuant to the December 22 transaction with Spear?

Required: Discuss the issues raised by Mirk, setting forth your conclusions and reasons therefor.

N87

Number 2 (Estimated time — — 15 to 20 minutes)

On May 1, Starr Corp., a manufacturer and supplier of computers, mailed a proposed contract to Magic, Inc., offering to sell 20 items of specified computer equipment for \$18,000. Magic was engaged in the business of selling computers to the public. Magic accepted Starr's offer by executing and returning the contract to Starr. Starr failed to sign the contract.

On May 15, Starr advised Magic by telephone that, due to certain market conditions, the price of computer parts had increased. Therefore, in order to avoid a loss

on the sale to Magic, Starr requested an increase in the sales price to \$20,000, which was orally agreed to by Magic. On May 17, Starr sent to Magic a signed letter acknowledging this agreement. Magic did not respond to the letter.

On September 15, Starr notified Magic that the equipment was ready for delivery. Due to substantial changes in computer technology subsequent to May 15, Magic indicated that it no longer wanted the equipment and that it would not pay for it. Starr was unable to resell the computer equipment for any price despite its reasonable efforts to do so. Therefore, Starr commenced a breach of contract action against Magic. Magic asserted the following defenses:

- The May 1 written contract between Starr and Magic is not enforceable because of the statute of frauds.
- Even if the May 1 contract is enforceable, the May 15 oral agreement to change the price of the equipment is not enforceable because the agreement lacked consideration and failed to satisfy the statute of frauds.
- In any event, Starr is not entitled to recover the full sales price because the equipment is still in Starr's possession.

Required: Discuss Magic's assertions, indicating whether each is correct or incorrect and setting forth the reasons for any conclusions stated.

N86

Number 3 (Estimated time — — 15 to 20 minutes)

Finn, a junior member of the audit staff of a CPA firm, was assigned to assist the accountant-in-charge of the examination of the financial statements of Dark Manufacturing, Inc. Dark manufactures small motors and is located in Chicago. One facet of Finn's contribution to the examination of Dark is to examine the sales figures contained in the financial statements. Dark sells its motors to a broadly diversified range of buyers. The terms of the sales varied widely as to credit, delivery, security interests, and title. Finn remembered that one consideration in determining if a sale has taken place for accounting purposes is whether title to the goods has passed to the buyer. He also recalled that the Uniform Commercial Code's definition of a "sale" as "the passing of title from the seller to the buyer for a price." Finn examined the following representative samples of the types of transactions Dark enters into to determine whether they were in fact "sales":

Category One: The goods are unfinished motors which are on the assembly line and will be completed and boxed in the future. The contracts of sale involving these unfinished motors provided that the buyers will pick them up when available at Dark's loading platform. The contracts state that the motors have been sold to the buyer and title has passed to him upon execution of the contract.

Category Two: The goods are shipped to buyers pursuant to contracts which provide either "F.O.B. — buyer's place of business" or "F.O.B. — Dark's loading dock." In both instances Dark retains a security interest and files a financing statement.

Category Three: The goods have been warehoused by Dark in a public warehouse. By the terms of these contracts, Dark is obligated to deliver a negotiable warehouse receipt in some instances and a non-negotiable warehouse receipt in others.

Category Four: The goods were shipped to the buyer and were either rightfully or wrongfully rejected.

Category Five: The goods were shipped to the buyer who had 30 days to return the motors if they were not suitable for use in the buyer's manufacturing operation.

Category Six: Identified goods are sold to a buyer and have been made available to the buyer pursuant to a written contract that is silent as to the passage of title.

Category Seven: The goods were shipped to a buyer who has rightfully revoked his acceptance of the goods because of a substantial manufacturing defect. The buyer is still in possession of the goods.

Required: Answer the following, setting forth reasons for any conclusions stated.

What role does title play under the Uniform Commercial Code? Determine whether title has passed in each of the above seven categories of transactions.

M86

Number 3 (Estimated time — — 15 to 20 minutes)

King Department Store is in the business of selling men's and ladies' apparel. Ward & Co., CPAs, while performing its year-end audit of King, reviewed the following agreements which King entered into with Lutz, its largest supplier of merchandise, in December, 1985:

- On December 24, 1985, King entered into a sale or return contract with Lutz. King received delivery of the goods on December 28, 1985.
- On December 26, 1985, King signed an agreement to purchase 20 fur coats from Lutz for \$20,000. The contract required King to promptly pick up the goods at Lutz's warehouse. On December 31, 1985, King arrived at Lutz's warehouse, paying Lutz the \$20,000. Lutz tendered delivery of the furs but King refused to take possession since its truck was experiencing mechanical difficulties. The following day, King arrived to pick up the coats and was informed that a fire destroyed the furs on December 31.

Selected Questions

- On December 30, 1985, King entered into two contracts to purchase merchandise from Lutz. The contracts required that Lutz ship the goods by common carrier to King the following day, which it did. The shipping terms of the first contract were "F.O.B. King's Department Store." The second contract included the shipping term "C.I.F." (cost, insurance, and freight). Both shipments arrived at King's business on January 2, 1986.

King has adopted a calendar year for accounting purposes. Flaxx, the partner in charge of the audit, wishes to resolve the following issues pertaining to each of the transactions with Lutz:

- Who bears the risk of loss in each of the above transactions as of December 31, 1985?
- Whether title to the goods received by King as a result of the December 24 and December 30 contracts passed to King by December 31, 1985, and therefore should be included in King's ending inventory.
- Who is liable for the expenses relating to the transportation of the goods on the December 30 contracts?

The contracts between Lutz and King did not address the issues raised by Flaxx.

Required: Answer the following, setting forth reasons for any conclusions stated.

Discuss the issues raised by Flaxx.

N85

Number 4 (Estimated time — 15 to 20 minutes)

John Barr purchased a new fork-lift for use in his business from Fiber Corp. Fiber designs, manufactures, and assembles fork-lifts, shipping them directly to customers throughout the U.S. The contract between Barr and Fiber contained a clause in fine print disclaiming "all warranties express or implied other than the limited warranty provided for on the face of this contract." The limited warranty included in the contract provided that "the buyer's sole and exclusive remedy shall be repair or replacement of defective parts and the seller shall not be liable for damages or personal injuries." The contract was a standard form used by Fiber, and as a matter of policy Fiber does not negotiate the terms and conditions of the contract with its customers.

Within one week of the purchase date, Barr was seriously injured when the steering wheel locked causing him to lose control of the fork-lift. Barr brings an action against Fiber for the personal injuries that he sustained based on the following causes of action:

- Negligence
- Breach of warranty
- Strict liability in tort

Fiber has asserted that the action brought by Barr should be dismissed due to the disclaimer.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss in separate paragraphs the prerequisites necessary to sustain each of the three causes of action asserted by Barr.

b. Discuss the validity of the disclaimer with regard to the breach of warranty cause of action.

M85

Number 2 (Estimated time — 15 to 20 minutes)

Reed, a manufacturer, entered into an oral contract with Rocco, a retailer, to deliver 10 leather jackets to Rocco's place of business within 15 days. The total sales price was \$450. Prior to the delivery of the jackets the market price of leather increased drastically. Reed knew Rocco needed the jackets within the 15 days and telephoned Rocco stating that he would be unable to deliver the jackets unless the sales price was increased by \$100. Rocco agreed to the new price. The following morning Reed sent Rocco a signed letter indicating the new sales price and that the sale was for 10 leather jackets. Rocco received the letter the next day and has taken no further action.

Reed entered into an oral contract to purchase Smith's vacant building for \$50,000, giving \$5,000 as a deposit. The parties intended to reduce their agreement to writing at a later date. Pursuant to the oral contract, Reed took possession of the building with Smith's permission and made permanent and substantial improvements. Due to a rise in the price of similar real estate, Smith serves notice on Reed to vacate the premises, contending that the sales contract was unenforceable.

Required: Answer the following, setting forth reasons for any conclusions stated.

a. Discuss whether the original sales contract and the subsequent change in price by Reed are enforceable under the UCC Sales Article.

b. May Smith require Reed to vacate the building?

D. Secured Transactions

M88

Number 4 (Estimated time — 15 to 20 minutes)

Dunn & Co., CPAs, is auditing the 1987 financial statements of its client, Safe Finance. While performing the audit, Dunn learned of certain transactions that occurred during 1987 that may have an adverse impact on Safe's financial statements. The following transactions are of most concern to Dunn:

- On May 5, Safe sold certain equipment to Lux, who contemporaneously executed and delivered to Safe a promissory note and security agreement covering the equipment. Lux purchased the equipment for use in its business. On May 8, City Bank loaned Lux \$50,000, taking a promissory note and security agreement from Lux that covered all of Lux's existing and after-acquired equipment. On May 11, Lux

was involuntarily petitioned into bankruptcy under the liquidation provisions of the Bankruptcy Code and a trustee was appointed. On May 12, City filed a financing statement covering all of Lux's equipment. On May 14, Safe filed a financing statement covering the equipment it had sold to Lux on May 5.

- On July 10, Safe loaned \$600,000 to Cam Corp., which used the funds to refinance existing debts. Cam duly executed and delivered to Safe a promissory note and a security agreement covering Cam's existing and after-acquired inventory of machine parts. On July 12, Safe filed a financing statement covering Cam's inventory of machine parts. On July 15, Best Bank loaned Cam \$200,000. Contemporaneous with the loan, Cam executed and delivered to Best a promissory note and security agreement covering all of Cam's inventory of machine parts

and any after-acquired inventory. Best had already filed a financing statement covering Cam's inventory on June 20, after Best agreed to make the loan to Cam. On July 14, Dix, in good faith, purchased certain machine parts from Cam's inventory and received delivery that same day.

Required: Define a purchase money security interest. In separate paragraphs, discuss whether Safe has a priority security interest over:

- The trustee in Lux's bankruptcy with regard to the equipment sold by Safe on May 5.
- City with regard to the equipment sold by Safe on May 5.
- Best with regard to Cam's existing and after-acquired inventory of machine parts.
- Dix with regard to the machine parts purchased on July 14 by Dix.

VII. Property

A. Real and Personal Property

M89

Number 3 (Estimated time — 15 to 20 minutes)

On March 2, 1988, Ash, Bale, and Rangel purchased an office building from Park Corp. as joint tenants with right of survivorship. There was an outstanding note and mortgage on the building, which they assumed. The note and mortgage named Park as the mortgagor (borrower) and Vista Bank as the mortgagee (lender). Vista has consented to the assumption.

Wein, Inc., a tenant in the office building, had entered into a 10-year lease dated May 8, 1985. The lease was silent regarding Wein's right to sublet. The lease provided for Wein to take occupancy on June 1, 1985, and that the monthly rent would be \$5,000 for the entire 10-year term. On March 10, 1989, Wein informed Ash, Bale, and Rangel that it had agreed to sublet its office space to Nord Corp. On March 17, 1989, Ash, Bale, and Rangel notified Wein of their refusal to consent to the sublet. The following assertions have been made:

- The sublet from Wein to Nord is void because Ash, Bale, and Rangel did not consent.
- If the sublet is not void, Ash, Bale, and Rangel have the right to hold either Wein or Nord liable for payment of the rent.

On April 4, 1989, Ash transferred his interest in the building to his spouse.

Required: Answer the following, setting forth reasons for any conclusions stated.

- a. *For this item only*, assume that Ash, Bale, and Rangel default on the mortgage note, that Vista fore-

closes, and a deficiency results. Discuss the personal liability of Ash, Bale, and Rangel to Vista and the personal liability of Park to Vista.

- b. Discuss the assertions as to the sublet, indicating whether such assertions are correct and the reasons therefor.

- c. *For this item only*, assume that Ash and Rangel died on April 20, 1989. Discuss the ownership interest(s) in the office building as of April 5, 1989, and April 21, 1989.

C. Fire and Casualty Insurance

N88

Number 2 (Estimated time — 15 to 20 minutes)

Dunn & Co., CPAs, while performing the 1987 year-end audit of Starr Corp.'s financial statements discovered that certain events during 1987 had resulted in litigation.

Starr had purchased the warehouse on March 1, 1987. The contract between Birk and Starr provided for a closing on September 20, 1987. On July 1, 1987, Birk executed a contract to purchase the warehouse from Starr for \$200,000. On September 1, 1987, Birk contacted Starr and demanded that the purchase price be reduced to \$190,000 because of a sudden rise in interest rates and declining value of real estate. Starr orally agreed to change the price to \$190,000. On September 2, Birk sent Starr a signed memo confirming the reduction in price to \$190,000. Starr did not sign the memo or any other agreement reducing the price. On September 15, Starr, by telephone, informed Birk that it would not sell the warehouse for \$190,000. Birk refused to pay Starr \$200,000 and a closing never occurred.

Selected Questions

On October 30, 1987, a fire caused \$80,000 damage to the warehouse at a time when its fair market value was \$200,000. Starr had obtained a \$160,000 fire insurance policy on February 15, 1987, from Pica Casualty Co., covering the warehouse. On April 11, 1987, Starr obtained another fire insurance policy from Drake Insurance Co. covering the warehouse for \$40,000. Each policy contained an 80% coinsurance clause and a provision limiting each company's liability to its proportion of all insurance covering the loss. Pica has refused to pay any amount on its policy.

Starr commenced actions against Birk and Pica asserting the following:

- Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of \$200,000.
- Starr has an insurable interest in the warehouse covered under the policy with Pica.
- Starr has met the coinsurance requirement under Pica's policy.
- Starr is entitled to recover the entire \$80,000 from Pica.

Required: Discuss Starr's assertions, indicating whether such assertions are correct and the reasons therefor.

SELECTED ESSAYS — UNOFFICIAL ANSWERS

I. The CPA and the Law

N88

Answer 5 (10 points)

Crea will not be liable to the purchasers of the common stock. Although an offering of securities made pursuant to Regulation D is exempt from the registration requirements of the Securities Act of 1933, the antifraud provisions of the federal securities acts continue to apply. In order to establish a cause of action under Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934, the purchasers generally must show that: Crea made a material misrepresentation or omission in connection with the purchase or sale of a security; Crea acted with some element of scienter (intentional or willful conduct); Crea's wrongful conduct was material; the purchasers relied on Crea's wrongful conduct; and, that there was a sufficient causal connection between the purchasers loss and Crea's wrongful conduct.

Under the facts of this case, Crea's inadvertent failure to exercise due care, which resulted in Crea's not detecting the president's embezzlement, will not be sufficient to satisfy the scienter element because such conduct amounts merely to negligence. Therefore, Crea will not be liable for damages under Section 10(b) and rule 10b-5 of the Securities Exchange Act of 1934.

Crea is likely to be held liable to Safe Bank based on Crea's negligence despite the fact that Safe is not in privity of contract with Crea. In general, a CPA will not be liable for negligence to creditors if its auditor's report was primarily for the benefit of the client, for use in the development of the client's business, and only incidentally or collaterally for the use of those to whom the client might show the financial statements. However, a CPA is generally liable for ordinary negligence to third parties if the audit report is for the identified third party's primary benefit.

In order to establish Crea's negligence, Safe must show that: Crea had a legal duty to protect Safe from unreasonable risk; Crea failed to perform the audit with the due care or competence expected of members of its profession; there was a causal relationship between Safe's loss and Crea's failure to exercise due care; actual damage or loss resulting from Crea's failure to exercise due care. On the facts of this case, Crea will be liable based on negligence since the audited financial state-

ment reports were for the primary benefit of Safe, an identified third party, and Crea failed to exercise due care in detecting the president's embezzlement, which resulted in Safe's loss, i.e., Dark's default in repaying the loan to Safe.

M88

Answer 5 (10 points)

a. The December 5 oral agreement between Cream and Apple is unenforceable because the agreement failed to comply with the requirements of the statute of frauds. A contract that cannot possibly be performed within one year from the making of the contract falls within the provisions of the statute of frauds. As the facts clearly indicate, the December 5 oral agreement could not possibly be performed within one year of the making of the agreement (December 5, 1987) since the agreement required Apple to continue to perform until December 20, 1988. Therefore, the oral agreement is unenforceable.

b. The agreement between Nestar and Apple restricting Nestar from competing with Apple for three years within the city where Nestar's office and the majority of Nestar's clients were located is likely to be enforceable. An agreement not to compete will be enforceable if there has been a sale of a business including goodwill and the purpose of the restraint is to protect a property interest of the purchaser; the restraint is reasonable as to the geographic area covered; and the restraint is reasonable as to the time period. Under the facts of this case, the agreement not to compete is likely to be enforceable. The transaction involves the sale of Nestar's management consulting business and goodwill. The purpose of the restraint is to protect the goodwill. The three year time period is reasonable. The limitation on the geographic area covered by the restraint to only the city where Nestar's office and the majority of Nestar's clients are located appears to be reasonable.

c. Birk will prevail in its action against Kaye based on negligence. Kaye owed a duty to Birk to conduct the audit with due care. Kaye failed to conduct the audit with due care by issuing an unqualified opinion on Apple's 1987 financial statements when, in fact, Apple had made a material error by reporting all of the revenues related to the unenforceable December 5

agreement on its 1987 financial statements. Kaye's issuance of an unqualified opinion despite the material error caused Birk to suffer damages as evidenced by the drastic decrease in the market value of Apple stock.

M87

Answer 3 (10 points)

a. No. Since there is no accountant-client privilege recognized at common law and there is no applicable state statute which creates an accountant-client privilege, Clark & Wall will be required to produce its workpapers. Furthermore, the right to assert the accountant-client privilege generally rests with the client and not with the accountant.

b. The elements necessary to establish a cause of action for negligence against Clark & Wall are:

- A legal duty to protect the plaintiff (Dill) from unreasonable risk.
- A failure by the defendant (Clark & Wall) to perform or report on an engagement with the due care or competence expected of members of its profession.
- A causal relationship, i.e., that the failure to exercise due care resulted in the plaintiff's loss.
- Actual damage or loss resulting from the failure to exercise due care.

In addition to the foregoing, Dill must be able to establish that it is within a known and intended class of third party beneficiaries in order to recover damages from Clark & Wall for negligence. This is necessary because Clark & Wall has asserted that it is not in privity of contract with Dill.

c. The primary standards against which the accountant's conduct will be tested are GAAS. Such standards are generally known as "the custom of the industry." Failure by Clark & Wall to meet the standards of the profession will undoubtedly result in a finding of negligence. However, meeting the standard of the profession will not be conclusive evidence that Clark & Wall was not negligent, although it is of significant evidentiary value.

d. The requirements to establish actual or constructive fraud on the part of Clark & Wall are:

1. A false representation of fact by the defendant (Clark & Wall).
2. For actual fraud, knowledge by the defendant (Clark & Wall) that the statement is false (scienter) or that the statement is made without belief that it is truthful. Constructive fraud may be inferred from gross negligence or a reckless disregard for the truth.
3. An intention to have the plaintiff (Dill) rely upon the false statement.
4. "Justifiable" reliance upon the false statement.
5. Damage resulting from said reliance.

M86

Answer 2 (10 points)

The facts reveal negligence on Field's part in that it did not follow its own audit program nor did it make a proper investigation into the many irregularities and suspicious circumstances. Compliance with GAAP is of some evidentiary value to Field if it in fact complied with the principles set forth therein. However, the courts do not invariably accept GAAP as the conclusive test to disprove negligence. Furthermore, even if assuming GAAP were followed literally, GAAS certainly were not, under the facts stated.

Field will undoubtedly rely upon the privity defense to avoid liability to Slade, a third party to the Field-Tyler contract. However, most jurisdictions recognize the standing of a third party beneficiary to sue. Therefore, Slade would assert such status. In a majority of jurisdictions Slade would be regarded as a third party beneficiary if it is within a known and intended class of beneficiaries. Other jurisdictions have gone even further in recognizing a duty is owed to those whom the CPA should reasonably foresee as recipients of the financial statements for authorized business purposes. There are insufficient facts to determine whether Field knew that Tyler intended to use the audited financial statements to secure credit from Slade. Therefore, it is not possible to determine whether the privity defense will bar recovery.

Fraud does not require that the party suing be in privity of contract with the defendant. However, the most significant problem in proceeding based upon fraud is that fraud requires a knowledge of falsity (scienter) or a recognized substitute therefor. Based upon the facts, Field did not actually know of management's fraud. However, it may be guilty of conduct which may be deemed to be a reckless disregard for the truth. The courts also resort to the constructive fraud theory where the facts are compelling, i.e., a shutting of one's eyes to the obvious. Sometimes, the conduct is labeled gross negligence, and an inference of fraud may be drawn from this by the trier of fact.

N85

Answer 2 (10 points)

a. The role of the engagement letter is to set forth in writing the nature and limitations of the engagement and define the arrangement between the CPA and his client. The engagement letter should clearly and precisely state the type of engagement contemplated and the scope of such an undertaking. It should indicate the procedures and steps to be taken in the review and indicate the tests that will be performed. It should also state that the engagement cannot be relied upon to disclose errors, irregularities, or illegal acts, including fraud or defalcation, but the CPA will inform his client of any such matters that come to his attention. The engagement letter or an acknowledgement should be signed by the client. If the engagement letter is carefully prepared and if it spells out the engagement clearly, it

will play an important role if a dispute arises between the CPA and his client. The engagement letter will also help the courts to avoid any misunderstanding about the scope of the engagement.

b. Under such circumstances, the courts that have considered the question and SSARS No. 1 promulgated by the AICPA both impose a duty of inquiry when the CPA becomes aware of suspicious circumstances. Certainly, the mere reliance upon management's word is not sufficient. The facts indicated that Walker was "uneasy about certain figures and conclusions." The CPA has an obvious duty to the client, Monrad, to inquire into any suspicious circumstances of which he becomes aware.

c. Depending on the circumstances about who in management was involved and their ownership of stock, Monrad in its own right may bring an action or the shareholders may bring a derivative action against Mason & Dilworth on behalf of the corporation for negligently failing to detect the fraud. It is possible that an action based upon constructive fraud might also be asserted against the firm because the conduct might be categorized as gross negligence or a reckless disregard for the truth. Certainly, a shareholder in his own right and any of the lending institutions will assert this and privity of contract will not be a valid defense.

There is authority supporting the rights of third party plaintiffs to sue and to recover from the accountants based upon a negligently performed review. As a general rule, third parties, even though not parties to the contract, may successfully assert negligence if they can show that they are members of a class of persons intended to benefit from the services performed by the CPA and that this was reasonably foreseeable by the CPA.

M85

Answer 4 (10 points)

a. The bases for shareholders' and creditors' suits against Arthur & Doyle under federal securities acts include

- That a violation of the 1933 Act has occurred as a result of misstatements or omissions in the prospectus or elsewhere in the registration statement required in order to "sell" the securities. The Securities and Exchange Commission has ruled that the issuance and exchange of stock pursuant to a merger constitutes a "sale" within the meaning of the Securities Act of 1933.

- That a violation of the anti-fraud provisions of the 1934 Act and of Rule 10b-5 issued pursuant thereto has occurred since misstatements and omissions of material facts may be fraudulent. Additionally, the anti-fraud provision (Sec. 17) of the 1933 Act could be asserted.
- That a violation of the reporting requirements of the Securities Exchange Act of 1934 has occurred to the extent that false or misleading statements were included or material facts were omitted in the reports or other documents relating to the merger and which were filed with the SEC.
- That a violation of the proxy rules of the Securities Exchange Act of 1934 resulted from misstatements in or omissions from the merger proxy statement used in soliciting shareholder approval.

b. The bases for shareholders' and creditors' suits against Arthur & Doyle under state common law include

- Breach of contract. The relationship between Arthur & Doyle and Dunbar is contractual and requires that the CPAs' performance be rendered in a competent manner. The shareholders and creditors may claim breach of contract as third-party beneficiaries of the contract between the CPAs and Dunbar, since it could be held that the contract was entered into for their benefit and therefore they are in privity with the CPAs.
- Negligence. The shareholders and creditors could assert an independent claim of negligence in addition to the action for breach of contract. Negligence will be established when the CPAs fail to exercise reasonable care, taking into account such superior skill and knowledge the CPAs have or hold themselves out as having. Despite their lack of contractual privity, the shareholders and creditors will probably be able to successfully assert this action if they can show that they are members of a class of persons intended to benefit from the services performed by the CPAs and that this was reasonably foreseen by the CPAs.
- Actual fraud or constructive fraud. Recent court decisions have substantially eroded the privity barrier faced by third parties. Arthur & Doyle may be held liable for actual fraud if it can be shown that they intentionally deceived the shareholders and creditors. Arthur & Doyle may be held liable for constructive fraud if there are deficiencies or lapses in their professional work of such a magnitude that they constitute gross negligence or a reckless disregard for the truth.

II. Business Organizations

B. Partnerships and Joint Ventures

N88

Answer 4 (10 points)

a.1. The partnership cannot recover the $\frac{1}{2}\%$ commission from King because Rey had the apparent authority to reduce the commission to $1\frac{1}{2}\%$. The Uniform Partnership Act states that every partner is an agent of the partnership for the purpose of its business, and the act of every partner for apparently carrying on in the usual way the business of the partnership, binds the partnership, unless the partner so acting has in fact no authority to act for the partnership in the particular matter, and the person with whom the partner is dealing has knowledge of the fact that the partner has no such authority. In determining whether Rey had the apparent authority to bind the partnership, one must examine the circumstances and conduct of the parties and whether King reasonably believed such authority to exist. Because brokerage commissions are generally not uniform, it would be reasonable for King to believe that Rey had the authority to perform the transaction at $1\frac{1}{2}\%$ commission. Furthermore, King lacked knowledge of the restriction in the partnership agreement that prohibited Rey from reducing a commission below 2% without the other partners' consent. Therefore, King will not be liable for the $\frac{1}{2}\%$ commission.

a.2. The partnership can recover the $\frac{1}{2}\%$ commission from Rey because Rey violated the partnership agreement by reducing the commission to $1\frac{1}{2}\%$ without the partners' consent. Rey owes a duty to act in accordance with the partnership agreement.

b.1. Under the Uniform Partnership Act, a person admitted as a partner into an existing partnership is liable for all the obligations of the partnership arising before being admitted as though that person had been a partner when such obligations were incurred, except that this liability may be satisfied only out of partnership property. Thus, Park will not be personally liable for the partnership obligations arising prior to being admitted as a partner but would be liable based upon the extent of partnership interests held. Park will be personally liable for partnership obligations arising after being admitted to the partnership.

b.2. Stein will continue to be personally liable for partnership obligations arising prior to withdrawing from the partnership, unless Stein obtains a release from the existing creditors. Stein will have no liability for partnership obligations arising after actual and constructive notice of withdrawing was properly given. However, Stein may be personally liable for partnership obligations arising after withdrawing but prior to notice being given. Actual notice of Stein's withdrawal

was given by written notification to partnership creditors that had conducted business with the partnership prior to May 15. Constructive notice of Stein's withdrawal was given by proper publication in two newspapers to those third parties who had not dealt with the partnership, but may have known of its existence.

M88

Answer 3 (10 points)

A limited partnership is formed by two or more persons under a state's limited partnership statute, having as members one or more general partners and one or more limited partners. Two or more persons desiring to form a limited partnership must execute a certificate of limited partnership that must be filed in the office of the secretary of state, or other appropriate state or local office. A corporation may be formed only under a state incorporation statute that requires that one or more incorporators sign articles of incorporation which must be filed with the secretary of state.

Unless otherwise provided in the partnership agreement, or other agreements among the partners, a limited partnership interest is assignable in whole or in part. Similarly, in the absence of a restriction in the corporation's organizational documents or other agreements among the shareholders, shares of stock are freely transferable.

A limited partner's liability for partnership debts is generally limited to the partner's investment (capital contribution) in the partnership if the interest is fully paid and non-assessable and the partner does not participate in the daily management of the business. Likewise, a shareholder's liability for a corporation's debts is generally limited to the shareholder's investment (capital contribution) in the corporation.

A limited partner cannot participate in the daily operations of the partnership's business without losing limited liability. A shareholder who is not also an officer or a director cannot participate in the daily operations of the corporation's business. However, a shareholder owning voting stock has the right to vote for a board of directors, which will manage the business affairs of the corporation. The board of directors elects officers to run the daily operations of the corporation.

A limited partner is entitled to receive a share of the partnership's profits in the manner provided in the partnership agreement. On the other hand, whether a shareholder receives dividends is generally within the discretion of the board of directors.

N86

Answer 2 (10 points)

Typically, a general partnership is formed by an agreement between or among two or more persons, whether the agreement is written, oral, or implied. No filing of a partnership agreement is necessary in order

Unofficial Answers

to legally create the general partnership. In contrast, a limited partnership can only be formed where a state statute permits such formation. In addition, a duly signed certificate of limited partnership must be completed and filed with the appropriate state or local agency. A limited partnership, like a general partnership, is formed by two or more persons. However, unlike a general partnership, the limited partnership must have as members one or more general partners and one or more limited partners.

As a limited partner Slavin would not be able to participate in the daily management of the partnership's business if she wishes to limit her liability to her investment in the partnership. Thus, if Slavin intends to be involved in the daily operations of the partnership and to participate in the control of the partnership, she should consider becoming a general partner since general partners have rights in the management and conduct of the partnership's business.

In her capacity as a limited partner, Slavin's liability would be limited to her investment in the partnership for partnership debts if her interest is fully paid and nonassessable. However, if Slavin were to become a general partner, she would have unlimited liability which would allow partnership creditors to satisfy the debts of the partnership out of Slavin's personal assets.

Unless otherwise provided in the partnership agreement, Slavin has the right to assign her limited partnership interest and may also substitute the third party as a limited partner if all the members (except the assignor) consent thereto. Similarly, as a general partner, Slavin may assign her interest in the partnership and the third party may become a general partner if all of the partners consent.

A clause providing for the partnership to continue after the death of a general partner is valid and the partnership will continue. The clause has relatively little if any effect where a limited partner dies since the limited partnership continues upon the death of one of the limited partners, whether or not the clause is contained in the certificate.

N85

Answer 3 (10 points)

a. Nolan's property rights in the partnership prior to the conveyance of his partnership interest consisted of:

- His rights in specific partnership property. This right permitted Nolan to possess any item of partnership property for partnership purposes.
- His interest in the partnership. This interest is classified as personal property and is defined as the partner's share of the profits and surplus (including capital).
- His right to participate in the management of the partnership. This right entitles Nolan to an equal voice in the management and conduct of the partnership business.

Nolan's transfer of his partnership interest to Simon merely entitles Simon to receive Nolan's share of the profits and Nolan's interest in any property distributed by the partnership. Since Stein and Wolf have refused to admit Simon as a partner, Simon will not be entitled to participate in the management of the partnership or to acquire Nolan's right to possess specific partnership property.

b. Lemon's first assertion that he is an agent coupled with an interest is incorrect. An agency coupled with an interest in the subject matter arises when the agent has an interest in the property that is the subject of the agency. The fact that Lemon entered into a two-year written agency agreement with the partnership that would pay Lemon a commission clearly will not establish an interest in the subject matter of the agency. The mere expectation of profits to be realized or proceeds to be derived from the sale of the partnership's products is not sufficient to create an agency coupled with an interest. As a result, the principal-agency relationship may be terminated at any time.

Lemon's second assertion that the principal-agency relationship may not be terminated without cause prior to the expiration of its term is incorrect. Where a principal-agency relationship is based upon a contract to engage the agent for a specified period of time, the principal may discharge the agent despite the fact such discharge is wrongful. Although the principal does not have the right to discharge the agent, he does have the power to do so. Thus, Lemon may be discharged without cause.

Lemon's third assertion that he is entitled to damages because of the termination of the agency relationship is correct. Where a principal wrongfully discharges its agent, the principal is liable for damages based on breach of contract. Under the facts, Lemon's discharge by the partnership without cause constitutes a breach of contract for which Lemon may recover damages.

C. Corporations

M89

Answer 4 (10 points)

The assertion that it was improper for the board of directors to authorize the reacquisition of Cray's common stock while Cray was insolvent is correct. A board of directors may authorize and the corporation may reacquire its shares of stock subject to any restriction in the articles of incorporation, except that no reacquisition may be made if, after giving effect thereto, either the corporation would be unable to pay its debts as they become due in the usual course of business or the corporation's total assets would be less than its total liabilities. Because Cray was insolvent before and after the reacquisition of Cray's common stock, it was improper for the board of directors to authorize the reacquisition.

The assertion that the members of Cray's board of directors are personally liable because Cray reacquired its own shares of Cray stock while Cray was insolvent is incorrect. In general, directors who vote or assent to a reacquisition by the corporation of its own shares while the corporation is insolvent will be jointly and severally liable to the corporation. However, the directors will not be liable if they acted in good faith, in a manner they reasonably believed to be in the best interests of the corporation, and with such care as an ordinarily prudent person in a like position would use under similar circumstances. In performing their duties, directors are entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data prepared or presented by one or more officers or employees of the corporation whom the directors reasonably believe to be reliable and competent in the matters presented. The directors may rely on the same information prepared or presented by independent accountants that the directors reasonably believe to be within such person's professional competence. Based on the facts of this case, the directors' reliance on the reports and financial statements prepared by Cray's internal accounting department under the supervision of the treasurer and reviewed by its independent accountants was proper so long as the directors exercised due care, acted in good faith, and acted without knowledge that would cause such reliance to be unwarranted. In addition, the courts are precluded from substituting their business judgment for that of the board of directors if the directors have acted with due care and in good faith.

The assertion that Cray will be liable to the treasurer as a result of his termination by the board of directors is correct. An officer may be removed by the board of directors with or without cause whenever in its judgment the best interests of the corporation will be served by the removal. However, such removal is without prejudice to the contract rights of the person so removed. Thus, the board of directors had the power to remove the treasurer. The treasurer will prevail in a breach of contract action for damages against Cray because the firing violated the employment agreement.

N88

Answer 3 (10 points)

Dodd is entitled to recover workers' compensation benefits from Salam because Dodd was an employee of Salam, the injury was accidental, and the injury occurred out of and in the course of his employment with Salam. Based on the facts of this case, Dodd would be considered an employee and not an independent contractor because Salam had control over the details of Dodd's work by training Dodd to perform the services in a specified manner and Dodd was subject to Salam's supervision.

Dodd will be unsuccessful in his action against Salam based on negligence in training him because Dodd is an employee of Salam and Salam has complied with the applicable compulsory workers' compensation

statute by obtaining workers' compensation insurance. Under workers' compensation, an employee who receives workers' compensation benefits cannot successfully maintain an action for negligence against his employer seeking additional compensation. Therefore, whether Salam was negligent in training Dodd is irrelevant.

Dodd's action against Ace based on strict liability in tort will be successful. Generally, in order to establish a cause of action based on strict liability in tort, it must be shown that: the product was in defective condition when it left the possession or control of the seller; the product was unreasonably dangerous to the consumer or user; the cause of the consumer's or user's injury was the defect; the seller engaged in the business of selling such a product; the product was one which the seller expected to, and, did reach the consumer or user without substantial changes in the condition in which it was sold. Under the facts of this case, Ace will be liable based on strict liability in tort because all of the elements necessary to state such a cause of action have been met. The fact that Dodd is entitled to workers' compensation benefits does not preclude Dodd from recovering based on strict liability in tort from a third party (Ace).

Maple will not be liable to the restaurant patrons based on negligence, because shareholders of a corporation are insulated from personal liability for the negligence of the corporation or the corporation's employees. This rule would apply even though Maple owned a controlling interest in the common stock of Salam. Therefore, whether Salam or Dodd was negligent is irrelevant.

M88

Answer 3 (10 points)

A limited partnership is formed by two or more persons under a state's limited partnership statute, having as members one or more general partners and one or more limited partners. Two or more persons desiring to form a limited partnership must execute a certificate of limited partnership that must be filed in the office of the secretary of state, or other appropriate state or local office. A corporation may be formed only under a state incorporation statute that requires that one or more incorporators sign articles of incorporation which must be filed with the secretary of state.

Unless otherwise provided in the partnership agreement, or other agreements among the partners, a limited partnership interest is assignable in whole or in part. Similarly, in the absence of a restriction in the corporation's organizational documents or other agreements among the shareholders, shares of stock are freely transferable.

A limited partner's liability for partnership debts is generally limited to the partner's investment (capital contribution) in the partnership if the interest is fully paid and non-assessable and the partner does not participate in the daily management of the business. Likewise, a shareholder's liability for a corporation's debts

Unofficial Answers

is generally limited to the shareholder's investment (capital contribution) in the corporation.

A limited partner cannot participate in the daily operations of the partnership's business without losing limited liability. A shareholder who is not also an officer or a director cannot participate in the daily operations of the corporation's business. However, a shareholder owning voting stock has the right to vote for a board of directors, which will manage the business affairs of the corporation. The board of directors elects officers to run the daily operations of the corporation.

A limited partner is entitled to receive a share of the partnership's profits in the manner provided in the partnership agreement. On the other hand, whether a shareholder receives dividends is generally within the discretion of the board of directors.

N87

Answer 5 (10 points)

a. The initial capitalization of Creme in 1980 would result in \$20,000 being allocated to stated capital. Stated capital includes the par value of all shares of the corporation having a par value that have been issued. Therefore, the \$20,000 is calculated as follows: 40,000 shares issued \times 50¢ par value = \$20,000.

The \$15,000 of expenses incurred in organizing Creme would not affect stated capital. The Model Business Corporation Act permits payment of organization expenses out of the consideration received by it in payment for its shares if the payment does not render such shares assessable or unpaid. Thus, stated capital remains at \$20,000.

The 5% stock dividend would increase stated capital by \$1,000 calculated as follows: 40,000 shares \times 5% stock dividend = 2,000 shares \times 50¢ par value = \$1,000. The market price of the shares would have no effect on stated capital. Thus, stated capital is \$21,000.

The exercise of the stock option by Creme's president would increase stated capital by \$500 calculated as follows: 1,000 shares \times 50¢ par value = \$500. Neither the price paid by Creme's president nor the market price of the shares on the date the option was exercised would affect stated capital. Thus, stated capital is \$21,500.

The 2-for-1 stock split would not affect stated capital. Instead the par value of 50¢ per share would be reduced to 25¢ per share and the 43,000 shares of stock issued would be increased to 86,000 shares. Thus, stated capital remains at \$21,500.

The acquisition of 5,000 shares as treasury stock at \$30 per share by Creme would have no effect on stated capital under the cost method. Thus, stated capital remains at \$21,500.

The reissuance of the 3,000 shares of treasury stock at \$32 per share would also have no effect on stated capital under the cost method. Thus, stated capital remains at \$21,500.

b. Cash dividends may be declared and paid if the corporation is solvent and payment of the dividends would not render the corporation insolvent. Further-

more, each state imposes additional restrictions on what funds are legally available to pay dividends. One of the more restrictive tests adopted by many states permits the payment of dividends only out of unrestricted and unreserved earned surplus (retained earnings). The Model Business Corporation Act prohibits dividend distributions if, after giving effect to the distribution, the corporation's total assets would be less than its total liabilities.

N86

Answer 4 (10 points)

a. Generally, any person who is a holder of record of shares at least six months immediately preceding her demand or is the holder of record of at least 5% of all the outstanding shares of the corporation may, upon written demand, have the right to examine at any reasonable time for any proper purpose, the relevant books, records, and shareholder list of the corporation. In addition, any court of competent jurisdiction may upon proof by a shareholder of a proper purpose, irrespective of the period of time such shareholder has been a shareholder of record and irrespective of the number of shares held by her, compel the production for examination by the shareholder of such books, records, and shareholder list that is deemed relevant.

However, Rice may properly refuse to allow Mead to examine Sky's books, records, and shareholder list where the shareholder (Mead) has within two years sold or offered for sale any list of shareholders or has otherwise improperly used any information secured through any prior examination. Thus, it would appear that despite the fact that Mead has met the six-month holding requirement and holds in excess of 5% of the stock, Rice's refusal to permit Mead access to Sky's books, records, and shareholder list was proper since Mead had attempted to sell the shareholder list 13 months ago.

b. Mead personally does not have the right to remove Rice as president of Sky. However, Rice may be removed as the president of Sky by the board of directors whenever, in its judgment, the best interests of the corporation will be served. However, such removal is without prejudice to the contract rights of the person so removed. Thus, Rice may be removed with or without cause and the vote of the shareholders at its annual meeting is not required for such removal. However, if Rice is removed without cause Sky may be liable to Rice for breach of contract.

c. Mead is entitled to payment for her shares. A shareholder has the right to dissent from a merger and to obtain payment for her shares in the event that the corporation in which she is a shareholder is a party to a proposed plan of merger. If Mead strictly complies with the statutory requirements as a dissenter, she will be entitled to receive the fair value of her shares (an appraisal remedy). The fact that such a remedy is not provided for in the Articles of Incorporation is irrelevant where a state statute provides a dissenting shareholder with such a remedy.

M86

Answer 4 (10 points)

a. Although officers are generally insulated from personal liability for the negligence of the corporation or its employees, they are subject to personal liability in tort for their own negligent conduct or participation, even while engaged in corporate business activities. Shareholders generally will not be held liable for the negligence of the corporation unless they have in some way participated in the negligent act. Based on the facts presented, Major is personally liable to Fox for his own negligence even though the negligent acts were committed while engaged in corporate business activities. Major may also be liable because of his status as a shareholder if the corporate veil is pierced.

A corporation is liable under the doctrine of respondeat superior for the torts committed by its agents and employees (officers) in the course of their employment. Thus, Dix will also be liable to Fox for the negligence of Major.

The liability insurance carried by Dix will provide coverage for Dix and Major up to \$500,000 of liability to Fox. If Fox were to obtain a judgment in excess of \$500,000, Major and Dix would be liable for the uninsured balance.

b. Pine's assertion that Major is personally liable to the extent of \$6,000 for the common shares issued to Major is incorrect as to the dollar amount of his potential liability. Where a corporation issues par value stock in return for property or services rendered having a fair market value less than the par value, the shareholder purchasing the stock at the discounted price will remain potentially liable to the creditors of the corporation. The potential liability is the difference between the fair market value of the consideration given and the total par value of the stock. Stock issued at such a discounted price is commonly referred to as "watered stock." In this case Major's part payment by a promissory note and future services is insufficient consideration. Therefore, Major is potentially liable to Pine and the other corporate creditors for \$9,500—calculated as follows:

First Acquisition

Total par value (1,000 shares × \$10 par value)	\$10,000
Less: Consideration given (fair market value of property)	[3,500]
Potential liability on first acquisition	<u>\$ 6,500</u>

Second Acquisition

Total par value (1,000 shares × \$10 par value)	\$10,000
Less: Consideration given (services rendered)	[7,000]
Potential liability on second acquisition	<u>3,000</u>
Total Potential Liability	<u><u>\$ 9,500</u></u>

Pine's assertion that Major may be personally liable as a result of his directing customers to make checks payable to him in his individual capacity and depositing the checks in his individual account without recording the checks on the corporation's books is correct. Although a corporation may be established to limit the liability of the shareholders, the courts will pierce the corporate veil (disregard the corporate entity) and hold the shareholders personally liable when the corporation is used to perpetuate a fraud or in a closely-held corporation when the shareholders fail to treat the corporation as a separate business entity. The commingling of the corporation's funds with Major's own funds amounts to a disregard of the corporate entity and will likely subject Major to personal liability for the debts of Dix.

D. Estates and Trusts

M87

Answer 5 (10 points)

a. Yes. The elements necessary to set up a valid inter vivos trust have been met. John Reed as the creator (grantor or settlor) transferred stocks, bonds, and buildings which constituted the trust res (corpus or principal) to the trust with a present intent to create a trust. The trust instrument which designated Mini as trustee was set up for a lawful purpose and named Myrna as the income beneficiary and Rodney as the remainderman.

b. Where the trust instrument is silent as to the allocation of the trust receipts and disbursements to principal and income, the following rules apply:

With respect to the \$25,000 proceeds on the sale of the stock, most states require that the entire \$25,000 be allocated to principal. Therefore, the allocation of \$20,000 to income and \$5,000 to principal is incorrect.

The allocation of \$95,000 in rental receipts to income is correct since the entire amount was earned and received after the creation of the trust.

The allocation of the stock dividend to principal and income is incorrect in the vast majority of states. Even under the minority rule, an allocation of a stock dividend to principal based on the par value of the shares distributed is incorrect, i.e., 400 shares × \$5 par value = \$2,000. Under the majority rule, the entire stock dividend is allocated to principal.

The allocation of the full \$10,000 bond interest to income is incorrect since one-half (\$2,500) of the semi-annual payment received on April 1, 1986, had already accrued when the trust was created on January 1, 1986. Therefore, the proper allocation should be \$2,500 to principal and \$7,500 to income.

The \$35,000 of mortgage payments allocated to principal is correct to the extent such payments represent a repayment of the mortgage debt. Any portion of such payments which are deemed to be interest on the mortgage should be allocated to income.

Unofficial Answers

III. Contracts

N88

Answer 2 (10 points)

Starr's first assertion, that Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of \$200,000, is correct. An oral agreement modifying an enforceable existing contract is not enforceable if the modification is within the statute of frauds. A contract for the sale of real estate or a modification of such a contract falls within the provisions of the statute of frauds and therefore a writing signed by the party to be charged is required. The fact that Birk sent a signed memo to Starr is not effective because it was not signed by Starr. Furthermore, the agreement to reduce the purchase price to \$190,000 is not enforceable because Birk did not give any consideration for the modification. Birk had a pre-existing obligation to purchase the warehouse for \$200,000 and gave no new consideration for the modification of the price. The fact that Birk may have acted in good faith as a result of the decline in value of real estate and rise in interest rates will not be sufficient to make the oral agreement enforceable against Starr. Therefore, Birk's failure to pay \$200,000 as required by the July 1 contract constitutes a breach of that contract.

Starr's second assertion, that it has an insurable interest in the warehouse covered by the Pica policy, is correct. To constitute an insurable interest the element of financial or economic loss to the insured must be present. Furthermore, the insurable interest must be present at the time of the loss but need not be present at the time the policy was issued. Under the facts of this case, Starr had an insurable interest on the date of the loss (October 30) since it owned the warehouse on that date. Whether Starr had an insurable interest on February 15 will not affect Starr's right to recover from Pica.

Starr's third assertion, that it has met the coinsurance requirement under Pica's policy is correct.

Starr's fourth assertion, that Starr is entitled to recover the entire \$80,000 from Pica is incorrect. Starr is only entitled to receive \$64,000 from Pica calculated as follows:

$$\frac{\$160,000 \text{ (Amount of Insurance Coverage with Pica)}}{\$200,000 \text{ (Total Amount of Insurance on Warehouse)}} \times \$80,000 \text{ (Amount to be Paid)} = \$64,000$$

Thus, Pica's liability is limited to the amount its policy bears to the total amount of insurance on the warehouse.

M88

Answer 5 (10 points)

a. The December 5 oral agreement between Cream and Apple is unenforceable because the agreement failed to comply with the requirements of the statute of frauds. A contract that cannot possibly be performed within one year from the making of the contract falls within the provisions of the statute of frauds. As the facts clearly indicate, the December 5 oral agreement could not possibly be performed within one year of the making of the agreement (December 5, 1987) since the agreement required Apple to continue to perform until December 20, 1988. Therefore, the oral agreement is unenforceable.

b. The agreement between Nestar and Apple restricting Nestar from competing with Apple for three years within the city where Nestar's office and the majority of Nestar's clients were located is likely to be enforceable. An agreement not to compete will be enforceable if there has been a sale of a business including goodwill and the purpose of the restraint is to protect a property interest of the purchaser; the restraint is reasonable as to the geographic area covered; and the restraint is reasonable as to the time period. Under the facts of this case, the agreement not to compete is likely to be enforceable. The transaction involves the sale of Nestar's management consulting business and goodwill. The purpose of the restraint is to protect the goodwill. The three year time period is reasonable. The limitation on the geographic area covered by the restraint to only the city where Nestar's office and the majority of Nestar's clients are located appears to be reasonable.

c. Birk will prevail in its action against Kaye based on negligence. Kaye owed a duty to Birk to conduct the audit with due care. Kaye failed to conduct the audit with due care by issuing an unqualified opinion on Apple's 1987 financial statements when, in fact, Apple had made a material error by reporting all of the revenues related to the unenforceable December 5 agreement on its 1987 financial statements. Kaye's issuance of an unqualified opinion despite the material error caused Birk to suffer damages as evidenced by the drastic decrease in the market value of Apple stock.

N87

Answer 4 (10 points)

Stieb's first assertion, that Bold could not validly accept his offer dated April 5 because \$100 was inadequate consideration to hold the offer open, is incorrect. In general, the courts will not question the adequacy of consideration if the consideration has legal sufficiency and there is a bargained-for exchange. Adequacy of consideration has nothing to do with legal sufficiency. Thus the subject matter that the parties

have exchanged need not have approximately the same value. Based upon the facts, Bold's payment of the \$100 in exchange for Stieb's promise to keep the offer open was both legally sufficient and bargained for.

Stieb's second assertion, that his offer dated April 5 had terminated since he had revoked his offer prior to Bold's acceptance, is incorrect. An offer may be terminated by the offeror if a revocation is communicated to the offeree before the offeree accepts. In the majority of states revocation is effective upon receipt of the revocation by the offeree or the offeree's agent. On the other hand, acceptance will generally take effect at the time the acceptance is sent (dispatched) by an authorized means of communication. Bold used an authorized means of communication, i.e., the mail, which was the same method used by Stieb in making the offer. Therefore, Bold's acceptance and payment of \$100 on April 18 was effective on that date and formed an option contract. Thus, Stieb's letter of revocation mailed on

April 17 was not effective until Bold received the revocation on April 19 by which time an option contract had already been formed and the offer could not be revoked.

Stieb's third assertion, that even if his revocation was not effective, Bold's letter of May 15 was a counteroffer, which automatically terminated Bold's right to accept Stieb's offer of April 1, is incorrect. In general, the power of acceptance under an option contract is not terminated by a rejection or counteroffer made by the offeree, unless the requirements are met for the discharge of a contractual duty or the offeror changes its position to its detriment in reliance on such rejection or counteroffer. Although a rejection and/or counteroffer will terminate an offer when communicated, Bold's letter of May 15 will not terminate its right to exercise its option on the land because there was neither a discharge of a contractual duty nor reliance by Stieb to its detriment on the May 15 letter.

IV. Debtor-Creditor Relationships

B. Bankruptcy

M89

Answer 2 (10 points)

a. The requirements necessary for the commencement of an involuntary bankruptcy proceeding were met because the petition was filed by Lux, Squire, and Rusk, who were creditors of Tine with unsecured claims aggregating more than \$5,000. To properly commence an involuntary bankruptcy proceeding in which the debtor has 12 or more creditors with unsecured claims, three or more creditors with unsecured claims aggregating at least \$5,000 must sign the bankruptcy petition.

b. 1. The court may declare the January 31, 1989, mortgage delivered to Safe by Tine to be void as a preference. A preference occurs if there is a transfer of the interest in property:

- To or for the benefit of a creditor;
- For or on account of an antecedent debt owed by the debtor before such transfer was made;
- Made while the debtor was insolvent;
- Made within 90 days before the date of the filing of the bankruptcy petition (when the creditor is not an insider);
- That enables the creditor to receive more than the creditor would receive in a liquidation proceeding.

Under the facts of this case, the mortgage delivered by Tine to Safe was for Safe's benefit, on account of the \$250,000 owed to Safe, given while Tine was unable

to pay his current obligations (was insolvent), given on January 31, 1989 (which was within 90 days before the filing of the bankruptcy petition on March 23, 1989), and enabled Safe to receive more than it would have received in a liquidation proceeding (\$250,000 as a secured creditor vs. a lesser amount as an unsecured creditor in liquidation).

2. The court can except Tine's debt to Rich Bank from Tine's discharge in bankruptcy. In general, the bankruptcy court will except a debt from discharge if the debtor obtains money by use of a statement in writing respecting the debtor's financial condition that is materially false; the creditor to whom the debtor is liable for such money reasonably relied on the statement, and the debtor caused the statement to be made or published with intent to deceive.

Based on the facts of this case, Tine obtained a \$50,000 loan after furnishing Rich with personal financial statements, that he knew substantially overstated his net worth. Because it was difficult to detect the overstatement, Rich's reliance on the financial statements was reasonable. Therefore, the requirements necessary to except Rich's debt from Tine's discharge have been met.

N87

Answer 3 (10 points)

a. Yes. The requirements necessary for the filing of a valid petition in bankruptcy have been met. An involuntary case may be commenced against a person by the filing of a petition where the aggregate amount of

unsecured claims is at least \$5,000 and a sufficient number of creditors join in the filing of the petition. Where there are fewer than 12 creditors only one creditor need file the petition. Under the facts, the petition was validly filed against Mix because Able's unsecured claim was more than \$5,000 and because there were fewer than 12 creditors.

b. Lang's action as trustee to appoint Ring as the accountant for the bankruptcy estate was proper if such action was with the bankruptcy court's approval. The trustee, with the court's approval, may engage professional persons such as accountants on any reasonable terms and conditions.

Lang's inclusion of the inheritance in the property of the estate was also correct because property of the estate includes property that the debtor acquires or becomes entitled to acquire by inheritance within 180 days after the filing of the petition. By acquiring the right to inherit the property on December 15, 1986, which was less than 180 days after the filing of the petition on July 1, 1986, Mix's inheritance was properly included in the bankruptcy estate. Thus, Mix's receipt of the inheritance more than 180 days after the filing of the petition does not prevent the inclusion of the inheritance in the property of the estate.

c. The \$60,000 will be distributed to satisfy the claims and expenses of the bankruptcy estate in the following order of priority:

1. Carr's claim to the extent of the sale proceeds of the machinery in which Carr had a valid perfected security interest in bankruptcy. \$20,000

2. Administrative expenses including the expenses to maintain and sell the unsecured property of the estate (\$1,000) and Ring's fee for services rendered (\$3,000). 4,000

3. Unsecured claim for federal income taxes. 6,000

4. The unsecured claims of Able and Baker and the balance of Carr's claim, which have equal priority, will be paid proportionately as follows:

Able	$\frac{\$ 20,000}{\$ 120,000} \times \$ 30,000$	5,000
Baker	$\frac{\$ 40,000}{\$ 120,000} \times \$ 30,000$	10,000
Carr	$\frac{\$ 60,000}{\$ 120,000} \times \$ 30,000$	15,000
Total distributions		<u>\$60,000</u>

M86

Answer 5 (10 points)

a. The failure by Walsh to list or schedule a debt at anytime during the bankruptcy proceeding, if proven, would result in that debt being excepted from a discharge in bankruptcy. Such is the rule where the creditor is unable to file a proof of claim in time and lacks notice or actual knowledge of the case.

Proof of Walsh's failure to preserve financial records necessary to ascertain his financial condition, if unjustified, would result in Walsh being denied a discharge in bankruptcy. The purpose of this rule is to deny the debtor a discharge for his wrongdoing in connection with the bankruptcy proceeding.

The effect of Walsh obtaining money by use of false financial statements, if proven, would result in Salam's debt being excepted from a discharge in bankruptcy. In order to obtain such an exception from discharge Salam must establish that the money was obtained by the use of a statement in writing in respect to Walsh's financial condition that is materially false, on which Salam reasonably relied, and which Walsh made or published with intent to deceive.

b. On request of the trustee in bankruptcy or a creditor, and after notice and a hearing, the court will revoke a previously granted discharge in bankruptcy if:

- Such discharge was obtained through the fraud of the debtor and the party requesting that the discharge be revoked did not know of such fraud until after the discharge was granted; or
- The debtor acquired property that is property of the estate, or became entitled to acquire property that would be property of the estate, and knowingly and fraudulently failed to report the acquisition of, or entitlement to, such property, or to deliver or surrender such property to the trustee; or
- The debtor (1) has refused to obey any lawful order of the court, (2) has refused to testify on the ground of privilege against self-incrimination despite being granted immunity, or (3) has refused to testify after improperly invoking the constitutional privilege against self-incrimination.

The trustee in bankruptcy or a creditor may request a revocation of a discharge in bankruptcy under the first ground set forth above if such action is commenced within one year after the discharge was granted. If the requested revocation is based on the second or third grounds set forth above, then revocation must be sought within one year after the granting of such discharge or the date the case was closed, whichever is later.

M85

Answer 5 (10 points)

The trustee in bankruptcy may properly avoid or set aside the payment made by Baker to Nix on May 17 since it meets all the requirements necessary to establish a preferential transfer. In order to establish a preference, the trustee must show that the transfer

- Was to or for the benefit of a creditor.
- Was made for or on account of an antecedent debt owed by the debtor before such transfer was made.
- Was made while the debtor was insolvent.
- Was made within 90 days prior to the filing of the petition (when the creditor is not an insider).
- Enables the creditor to receive more than such creditor would receive in a liquidation proceeding.

There is a rebuttable presumption that the debtor is insolvent during the ninety days preceding the filing of the petition.

The transfer made by Baker to Wax on June 6 may not be avoided or set aside by the trustee. Since the transfer was intended by Baker and Wax to be a contemporaneous exchange for new value given to Baker

and was in fact a substantially contemporaneous exchange, the trustee may not avoid the transfer of the mortgage to Wax.

The payment made by Baker on June 16 for the electric bill may not be avoided by the trustee since the debt was incurred and paid in the ordinary course of Baker's business, within forty-five days after the debt arose, and in accordance with ordinary business terms.

The trustee was correct by including in the estate rents and property received as a result of the final divorce decree. Generally, property acquired after the filing of a bankruptcy petition is not part of the debtor's estate in bankruptcy but belongs to the debtor individually. However, there are certain exceptions to this rule. One such exception is rents earned on property of the debtor's estate. Thus, the rents received from July 1 through November 1 will be included in Baker's estate. Another such exception is property received by the debtor as a result of a final divorce decree within 180 days of the filing of the bankruptcy petition. Thus, the receipt of property by Baker on October 10 as a result of a final divorce decree falls within the 180 days after the filing of the bankruptcy petition on July 1 and is therefore included in the debtor's estate.

V. Government Regulation of Business

A. Regulation of Employment

N88

Answer 3 (10 points)

Dodd is entitled to recover workers' compensation benefits from Salam because Dodd was an employee of Salam, the injury was accidental, and the injury occurred out of and in the course of his employment with Salam. Based on the facts of this case, Dodd would be considered an employee and not an independent contractor because Salam had control over the details of Dodd's work by training Dodd to perform the services in a specified manner and Dodd was subject to Salam's supervision.

Dodd will be unsuccessful in his action against Salam based on negligence in training him because Dodd is an employee of Salam and Salam has complied with the applicable compulsory workers' compensation statute by obtaining workers' compensation insurance. Under workers' compensation, an employee who receives workers' compensation benefits cannot successfully maintain an action for negligence against his employer seeking additional compensation. Therefore, whether Salam was negligent in training Dodd is irrelevant.

Dodd's action against Ace based on strict liability in tort will be successful. Generally, in order to establish a cause of action based on strict liability in tort, it must be shown that: the product was in defective condition when it left the possession or control of the seller; the product was unreasonably dangerous to the consumer or user; the cause of the consumer's or user's injury was the defect; the seller engaged in the business of selling such a product; the product was one which the seller expected to, and, did reach the consumer or user without substantial changes in the condition in which it was sold. Under the facts of this case, Ace will be liable based on strict liability in tort because all of the elements necessary to state such a cause of action have been met. The fact that Dodd is entitled to workers' compensation benefits does not preclude Dodd from recovering based on strict liability in tort from a third party (Ace).

Maple will not be liable to the restaurant patrons based on negligence, because shareholders of a corporation are insulated from personal liability for the negligence of the corporation or the corporation's employees. This rule would apply even though Maple owned a controlling interest in the common stock of Salam. Therefore, whether Salam or Dodd was negligent is irrelevant.

Unofficial Answers

B. Federal Securities Acts

N85

Answer 5 (10 points)

a. There are four elements or factors to be considered in determining whether an offering of securities is subject to the registration requirements of the Securities Act of 1933. These are:

- The use of interstate commerce, e.g., the mails, in connection with the offer to sell or the sale of securities.
- The offering of said securities is to the "public."
- The offering or sale is made by an issuer, controlling person, or "statutory" underwriter.
- There is no relevant exemption available.

b. Since the sale of equity securities results in more than 500 persons owning Fancy stock, coupled with the fact that Fancy will have more than \$3 million of assets, the corporation will be subjected to the full application of the Securities Exchange Act of 1934. As such, it will be required to register pursuant to the Act and thereby become subject to the Act's reporting, insider trading, proxy, and other requirements.

c. The Securities Act of 1933 provides that where there is a violation of the Act as a result of the failure

to file a registration statement, the parties responsible shall be liable upon tender of the securities purchased for the amount paid, plus interest, less any distributions received. Damages are recoverable even if the party no longer owns the securities. Criminal penalties of a fine or imprisonment or both are applicable to any person who willfully violates the Securities Act of 1933.

d. An offering pursuant to Regulation D is exempt from registration. Regulation D is intended to permit exemption from registration of limited offers and sales by small businesses in need of capital.

1. There are two kinds of investors under Rule 505 of Regulation D: accredited investors as defined in the Regulation and all others who are designated as non-accredited investors. An unlimited number of accredited investors is permitted, but a maximum of 35 non-accredited investors is permitted.

2. Under Rule 505, if non-accredited investors are involved and Fancy is a non-reported company under the Securities Exchange Act of 1934, it must supply audited financial statements for one year. If an audit of the most recent year would involve unreasonable effort or expense, an audited balance sheet only, dated within 120 days of the start of the offering, is permitted.

3. Rule 505 prohibits any general solicitation or general advertising of the securities within a 12-month period.

VI. Uniform Commercial Code

A. Commercial Paper

M87

Answer 2 (10 points)

a. *Checks paid to fictitious payees.* Hex will bear the ultimate loss on these items (the fictitious or non-existent "employees" and the fictitious suppliers). As a general rule, forged signatures of drawers and forged indorsements are real defenses which are valid even against a holder in due course. However, when some of these activities are engaged in by the employees of an employer-drawer of the checks, a different rule is applied. Essentially, this rule negates these real defenses in certain cases thereby shifting the loss to the employer-drawer. The key rule is contained in the Uniform Commercial Code's Article on Commercial Paper which deals with "Imposters; Signature of Payee." In essence, this rule makes the indorsement or signature of the agent or employee of the drawer (Hex) "effective" where the agent has supplied the drawer the name of the payee intending the latter to have no such interest.

Insofar as Omega is concerned, it will be treated as if it had honored valid orders to pay and need not refund to Hex the amounts it paid. The orders are valid since the forged indorsements are not treated as unauthorized.

b. *Checks which contain the forged signature of the treasurer.* From the facts it is apparent that the treasurer had the authority to sign checks and not the assistant treasurer or head of payroll. Thus, the forging of the treasurer's signature was an "unauthorized signature" under the UCC.

As to these checks, the UCC provides that such signatures are wholly inoperative since the guilty parties had no authority to sign the treasurer's or any other authorized party's name as the drawer on behalf of Hex.

As between Hex and Omega, there is an obligation on the part of the bank to know the signatures of its drawer-depositors. Since Omega has paid the items it cannot recoup the loss from Hex. However, the bank has two possible ways to escape liability to Hex. First, it can resort to the UCC section which imposes upon a customer to whom items (checks) are returned, a duty

to exercise reasonable care and promptness in discovering and reporting unauthorized signatures. Another possibility is to establish negligence on the part of Hex which substantially contributed to the forgeries. Unless the bank can demonstrate that one of these exceptions applies, it will bear the loss.

C. Sales

M89

Answer 5 (10 points)

The assertion that as of March 3, 1989 the risk of loss on the disk drive remained with Xeon is correct. Under the UCC Sales Article, if the agreement between the parties is otherwise silent, risk of loss passes to the buyer on the buyer's receipt of the goods if the seller is a merchant. Under the facts, Xeon is a merchant because it sells computer systems. Therefore, the risk of loss remained with Xeon because the disk drive was never received by Pine.

The assertion that Meed acquired no rights in the CPU as a result of the March 18, 1989 transaction is incorrect. Under the UCC Sales Article, any entrusting of possession of goods to a merchant who deals in goods of that kind gives the merchant power to transfer all rights of the entruster to the buyer in the ordinary course of business. Entrusting includes any delivery and any acquiescence in retention of possession regardless of any condition expressed between the parties to the delivery or acquiescence, and regardless of whether the possessor's disposition of the goods have been such as to be larcenous under the criminal law. For the merchant to acquire the power to transfer ownership and title, the entruster must be the rightful owner. Under the facts of this case, Pine had title at the time the CPU was returned to Xeon for repairs and this constituted an entrusting that gave Xeon the power to transfer all of Pine's rights in the CPU to Meed.

The assertion that Jensen's security interest in the word processors never attached and therefore Jensen's security interest is not enforceable against Pine with respect to the word processors is incorrect. A security interest in collateral will attach if: the collateral is in the possession of the secured party under an agreement, or the debtor has signed a security agreement that contains a description of the collateral; the secured party has given value; and the debtor has rights in the collateral. Based on the facts, Jensen's security interest attached on April 12, 1989, when Jensen sold and Pine received the word processors and Jensen received a security agreement executed by Pine that described the word processors. On attachment, Jensen's security interest became enforceable against Pine.

The assertion that Jensen has a superior security interest to Pine's bank is incorrect. Although Jensen has a purchase money security interest to the extent the security interest is taken by Jensen to secure the purchase price, Jensen's security interest will not be

perfected by attachment alone. Jensen must file a financing statement to perfect its security interest because the collateral involved is goods used for business purposes and not consumer goods. Therefore, Jensen has an unperfected security interest in the word processors and the bank obtained a superior security interest by perfecting.

N88

Answer 3 (10 points)

Dodd is entitled to recover workers' compensation benefits from Spear because Dodd was an employee of Salam, the injury was accidental, and the injury occurred out of and in the course of his employment with Salam. Based on the facts of this case, Dodd would be considered an employee and not an independent contractor because Salam had control over the details of Dodd's work by training Dodd to perform the services in a specified manner and Dodd was subject to Salam's supervision.

Dodd will be unsuccessful in his action against Salam based on negligence in training him because Dodd is an employee of Salam and Salam has complied with the applicable compulsory workers' compensation statute by obtaining workers' compensation insurance. Under workers' compensation, an employee who receives workers' compensation benefits cannot successfully maintain an action for negligence against his employer seeking additional compensation. Therefore, whether Salam was negligent in training Dodd is irrelevant.

Dodd's action against Ace based on strict liability in tort will be successful. Generally, in order to establish a cause of action based on strict liability in tort, it must be shown that: the product was in defective condition when it left the possession or control of the seller; the product was unreasonably dangerous to the consumer or user; the cause of the consumer's or user's injury was the defect; the seller engaged in the business of selling such a product; the product was one which the seller expected to, and, did reach the consumer or user without substantial changes in the condition in which it was sold. Under the facts of this case, Ace will be liable based on strict liability in tort because all of the elements necessary to state such a cause of action have been met. The fact that Dodd is entitled to workers' compensation benefits does not preclude Dodd from recovering based on strict liability in tort from a third party (Ace).

Maple will not be liable to the restaurant patrons based on negligence, because shareholders of a corporation are insulated from personal liability for the negligence of the corporation or the corporation's employees. This rule would apply even though Maple owned a controlling interest in the common stock of Salam. Therefore, whether Salam or Dodd was negligent is irrelevant.

M88

Answer 2 (10 points)

As of December 31, 1987, Spear bears the risk of loss for the computers on the December 20 contract with Pica. The shipping term "F.O.B.—Spear's loading dock" designates a shipment contract. In general, risk of loss passes to the buyer (Pica) in a shipment contract when the goods are duly delivered to the carrier. However, where a tender or delivery of goods so fails to conform to the contract as to give a right of rejection, the risk of their loss remains on the seller until cure or acceptance. Thus, the failure of the shipment to conform to the contract constitutes a breach that permits Pica to reject the computers, thereby resulting in Spear bearing the risk of loss for the computers while they are in transit.

With respect to the December 22 contract, the risk of loss as of December 31, 1987, remains with Spear. Unless otherwise agreed, the risk of loss in a sale on approval contract does not pass to the buyer until the buyer accepts the goods. Under the facts of this case, Rusk had not yet accepted the computers as of December 31, 1987. Therefore, the risk of loss on the computers as of December 31, 1987, remains with Spear.

As of December 31, 1987, Spear has title to the 15 computers purchased from Larson under the December 21 contract because a person with voidable title has the power to transfer good title to a good faith purchaser for value. Larson has voidable title because he paid for the computers with an insufficient funds check. Spear is a good faith purchaser for value because it paid Larson \$20,000 and was unaware that Larson's check to Xeon was dishonored. The UCC Sales Article provides that when goods have been delivered under a transaction of purchase, the purchaser has the power to transfer good title even though the delivery was in exchange for a check that is later dishonored. Thus, Spear has good title to the computers as of December 31, 1987, despite Larson's check being dishonored, because it purchased and received the computers on December 21, 1987.

With respect to the December 22 sale on approval contract, title to the two computers remains with the seller until the buyer accepts the computers, because the contract is silent as to when title passes. Therefore, as of December 31, 1987, Spear retains title to the two computers because Rusk had not yet notified Spear whether it would accept the computers, and the time for such notification had not yet passed.

Because the December 22 contract between Spear and Rusk is a sale on approval contract, the computers are not subject to the claims of the creditors of the buyer (Rusk) until acceptance.

N87

Answer 2 (10 points)

Magic's first assertion, that the original contract between Starr and itself is not enforceable because of the statute of frauds, is incorrect. The sale of computer equipment is a transaction in goods and thus is governed by the UCC Sales Article. This Article provides that a contract for the sale of goods for the price of \$500 or more is not enforceable unless there is some writing sufficient to indicate that a contract for sale has been made between the parties which is signed by the party against whom enforcement is sought. Since the sales price is \$18,000, the statute of frauds applies. Magic's execution of the written contract will satisfy the statute of frauds since Magic is the party against whom enforcement of the contract is being sought.

Magic's second assertion, that the oral agreement to change the price of the equipment is not enforceable because the agreement lacked consideration and failed to satisfy the statute of frauds, is incorrect. Under the UCC Sales Article, an agreement to modify a contract for the sale of goods needs no consideration to be binding. However, the modification must meet the test of good faith, which is defined under the UCC as "honesty in fact in the conduct or transaction concerned and the observance of reasonable commercial standards of fair dealing in the trade." Based upon the facts, it appears that a shift in the market that will result in Starr bearing a loss on the sale to Magic will satisfy the requirement of good faith. In addition, the agreement modifying the sales price must meet the requirements of the statute of frauds if the contract, as modified, is within its provisions. Under the facts, the contract as modified by Magic and Starr, falls within the provisions of the statute of frauds and thus the statute of frauds must be satisfied. Magic's oral agreement to the modification is not sufficient to satisfy the statute of frauds. However, the statute of frauds will be satisfied if: both parties are merchants; a writing in confirmation of the agreement which is sufficient against the sender is received; the recipient receives the writing within a reasonable time; the recipient has reason to know the contents of the writing; and, the recipient fails to give written notice of objection to the contents of the writing within ten days after it is received. As the facts clearly indicate, the mailing of the signed letter by Starr to Magic on May 17 satisfied the aforementioned requirements and thus the modification agreement is enforceable.

Magic's third assertion that Starr is not entitled to recover the full sales price for the equipment is incorrect. The UCC provides that a seller may recover the price of goods identified to a contract and in the possession of the seller if the seller is unable after reasonable effort to resell them at a reasonable price or the

circumstances reasonably indicate that such effort will be unavailing. Under the facts of the case at hand, Starr is entitled to recover the full sales price of \$20,000 because the equipment could not be resold for any price.

N86

Answer 3 (10 points)

The draftsmen of the Uniform Commercial Code assigned a relatively minor role to title. The status of title is irrelevant in allocating risk of loss, determining remedies, and making other determinations under the UCC. Each of these issues is dealt with independent of title. However, the passage of title for a price is the basic definition of a sale which is the focus of Article 2 of the UCC.

Category One: Title has not passed upon execution of the contract by the parties. Although the UCC favors the contractual allocation of title by the parties, it does not permit a sale to take place until the goods are in existence and have been identified to the contract.

Category Two: In the absence of an explicit agreement, the term "F.O.B.-buyer's place of business" is a destination point contract, and title passes on tender at the destination. On the other hand, the term "F.O.B.-Dark's loading dock" is a shipping point contract, and title passes to the buyer at the time and place of shipment. Taking a security interest and filing a financing statement is irrelevant for purposes of determining whether title has passed.

Category Three: Title will pass upon delivery of the negotiable warehouse receipt to the buyer in this type of transaction. Likewise, title will pass upon delivery of the warehouse receipt if it is nonnegotiable.

Category Four: A rejection or other refusal by the buyer, whether or not justified, revests title in the seller.

Category Five: This is a sale on approval transaction and therefore title passes to the buyer when the goods are accepted.

Category Six: Title passed at the time the contract was made because the goods were identified and available at that time.

Category Seven: Since the revocation of acceptance of the goods is rightful, title revests in the seller upon revocation of the acceptance.

M86

Answer 3 (10 points)

In the absence of an agreement to the contrary, King bears the risk of loss for the goods received on December 28, 1985 since the risk of loss on a sale or return contract passes to the buyer in accordance with the shipping terms of the contract. The fact that King received the goods on December 28, 1985, clearly indicates that the risk of loss passed to King prior to December 31, 1985. With respect to the destruction of the fur coats, the risk of loss on December 31, 1985, was on Lutz since King never received the coats. Where the seller is a merchant, as is the case here, the risk of loss passes to the buyer upon the buyer's receipt of the goods. The December 30 contract containing the delivery term "F.O.B. purchaser's business" is a destination contract and the risk of loss in such a contract passes to the buyer when the goods are so tendered at the point of destination as to enable the buyer to take delivery. Thus, the risk of loss on December 31 remained with Lutz since the merchandise did not arrive at King's business until January 2, 1986. The second contract entered into on December 30 containing the delivery term "C.I.F." is a shipping point contract whereby the risk of loss passes to the buyer when the goods are duly delivered to the carrier. Of course in either of the December 30 contracts, the party bearing the risk of loss may be entitled to recover damages from the carrier or if insurance is provided for, as in the "C.I.F." contract, from the insurance company.

Unless otherwise agreed, title in a sale or return contract passes to the buyer at the time and place the seller completes his performance with reference to the physical delivery of the goods. Title remains with the buyer until the buyer returns the goods to the seller. Therefore, King should include the goods on sale or return in its ending inventory since title had passed, at the latest, when the goods were received on December 28 and the goods had not been returned by December 31. Title to the merchandise on the December 30 contract containing the delivery term "F.O.B. purchaser's business" remained with the seller until the goods were tendered at the point of destination, i.e., the purchaser's business. Thus, the goods should not be included in King's ending inventory since the goods were not delivered to King's business until January 2, 1986. Conversely, the December 30 contract containing the delivery term "C.I.F." resulted in title being transferred to King on December 31, 1985, the day the carrier received the goods. Such is the rule since the "C.I.F." term is a shipping point contract whereby title passes to the buyer at the time and place of shipment. Therefore, the goods should be included in King's ending inventory despite King's lack of physical possession.

Since the December 30 agreements between King and Lutz did not stipulate who would pay the expenses relating to the transportation of the goods, Lutz is obligated to pay for transporting the goods to King's place

Unofficial Answers

of business pursuant to the "F.O.B. purchaser's business" term. Under the "C.I.F." contract King is obligated to pay Lutz a lump sum covering the cost of the goods, insurance, and freight to the destination.

N85

Answer 4 (10 points)

a. *Negligence.* In order to establish a cause of action based on negligence Barr must establish the following elements:

- That the defendant owed a legal duty to the plaintiff.
- That the defendant breached that duty.
- That the plaintiff sustained an actual loss or damages.
- That the breach of duty was the proximate cause of the plaintiff's actual loss or damages.

In determining if negligence is present the court will consider whether the defendant acted as a reasonably prudent person under the circumstances. Included in the reasonably prudent person test is whether the risk of harm was foreseeable.

Breach of Warranty. Since the sale of goods (the fork-lift) is involved in the contract, the UCC Sales Article applies. Because the seller would be regarded as a merchant, an implied warranty of merchantability is created. In order to establish a breach of this warranty, the plaintiff (Barr) must show:

- That the fork-lift was not fit for the ordinary purposes intended and
- That as a result of the breach of warranty, the plaintiff sustained a loss.

Strict Liability in Tort. Generally, the elements necessary to establish a cause of action based on strict liability in tort are as follows:

- That the product was in defective condition when it left the possession or control of the seller.
- That the product was unreasonably dangerous to the consumer or user.
- That the cause of the consumer's or user's injury was the defect.
- That the seller engaged in the business of selling such a product.
- That the product was one which the seller expected to and did reach the consumer or user without substantial changes in the condition in which it was sold.

Proof of fault is not a requirement to establish a cause of action in strict liability.

b. A proper disclaimer will permit the seller to exclude the implied warranty of merchantability. Under

the facts, the disclaimer would appear to be invalid since a written disclaimer of the implied warranty of merchantability must be conspicuous and, arguably, the language in the contract is not acceptable under the UCC. In this case the disclaimer was in fine print and therefore not conspicuous. In addition, the disclaimer may be considered unconscionable since the contract was standardized and no bargaining of the terms of the contract was permitted. It should be pointed out that although consequential damages may be limited or excluded, in the case of consumer goods limitation of consequential damages for personal injuries is *prima facie* unconscionable. However, since the facts do not relate to consumer goods, such limitation of damages is not *prima facie* unconscionable but may be proved to be unconscionable.

M85

Answer 2 (10 points)

a. The sale of leather jackets is governed by the Uniform Commercial Code Sales Article which applies to transactions in goods. Under the Uniform Commercial Code, an oral contract for the sale of goods under \$500 does not fall within the provisions of the statute of frauds. Thus, the contract between Reed and Rocco is enforceable by either party without the necessity of a signed writing since the sales price is \$450. The UCC provides that an agreement to modify a contract for the sale of goods needs no consideration to be binding. However, the modification made must meet the test of good faith. The modification must also satisfy the requirements of the statute of frauds if the contract, as modified, falls within its provisions. Whether Reed acted in good faith is determined by an examination of the facts. Here, the shift in the market may satisfy the requirement of good faith if Reed can show that he would have suffered a loss had he sold the jackets at \$450. However, if Reed refused to sell the jackets at \$450 merely to derive a greater profit, with knowledge that Rocco was in immediate need of the goods, the modification may not meet the test of good faith.

Since the sales price increased from \$450 to \$550, the contract must satisfy the statute of frauds in order to be enforceable. The UCC statute of frauds may be satisfied by a confirmation if

- Both parties are merchants.
- It is in writing.
- The writing is signed by the sender.
- The writing states the quantity.
- The writing is received by the recipient within a reasonable time.
- The recipient has reason to know the contents of the writing.
- The recipient fails to give written notice of objection to its contents within ten days after receipt.

As the facts clearly indicate, the mailing of the signed letter by Reed to Rocco the day after the con-

tract was orally modified, coupled with Rocco's failure to object within ten days after receipt will satisfy the requirements of the statute of frauds.

b. No. As a general rule, a contract for the sale of real property must be supported by a written memo signed by the party to be charged. However, an oral contract to sell real property may be removed from the statute of frauds where there has been part performance and reasonable reliance on the oral contract. The part payment of the sales price by Reed, in addition to Reed's taking possession of the building with Smith's consent and making permanent and substantial improvements, generally will prevent Smith from setting the contract aside or requiring Reed to vacate the building.

D. Secured Transactions

M88

Answer 4 (10 points)

A purchase money security interest is an interest in personal property or fixtures that secures payment or performance of an obligation and that is (1) taken or retained by the seller of the collateral to secure all or part of its price, or (2) taken by a person who by making advances or incurring an obligation gives value to enable the debtor to acquire rights in or the use of collateral if such value is in fact so used.

Safe's security interest has priority over the rights of the trustee in bankruptcy. The UCC Article on Secured Transactions states that a lien creditor includes a trustee in bankruptcy from the date of the filing of the petition. Under the general rule, an unperfected security interest is subordinate to the rights of a person who becomes a lien creditor before the security interest is perfected. However, if the secured party files with respect to a purchase money security interest before or within 10 days after the debtor receives possession of the collateral, he takes priority over the rights of a lien creditor that arise between the time the security interest attaches and the time of filing. Under the facts of our case, Safe has a purchase money security interest in the equipment because the security interest was taken by Safe to secure the price. Therefore, because Safe filed

a financing statement on May 14 (within 10 days after Lux received possession of the equipment) it has a priority security interest over the trustee in bankruptcy (lien creditor) whose claim arose between the time the security interest attached (May 5) and the time of filing (May 14).

Safe has a priority security interest in the equipment over City. A purchase money security interest in collateral other than inventory has priority over a conflicting security interest in the same collateral if the purchase money security interest is perfected at the time the debtor receives possession of the collateral or within 10 days thereafter. Because Safe has a purchase money security interest in the equipment that was perfected by filing a financing statement on May 14 (within 10 days after Lux received possession of the equipment on May 5), Safe has a priority security interest over City despite City's perfection of its security interest on May 12.

Best's security interest in the inventory has priority over Safe's security interest. In general, conflicting perfected security interests rank according to priority in time of filing or perfection. Priority dates from the time a filing is first made covering the collateral or the time the security interest is first perfected, whichever is earlier, provided that there is no period thereafter when there is neither a filing nor perfection. In this case, because both Best's and Safe's security interests were perfected by filing, the first to file (Best) will have a priority security interest. The fact that Best filed a financing statement prior to making the loan will not affect Best's priority.

Safe will not have a priority security interest over Dix because Dix is a buyer in the ordinary course of business and will take free of Safe's perfected security interest. Dix is a buyer in the ordinary course of business because Dix acted in good faith when purchasing the machine parts in the regular course of Cam's business. The UCC Article on Secured Transactions states that a buyer in the ordinary course of business takes free of a security interest created by his seller even though the security interest is perfected and even though the buyer knows of its existence. Therefore, Dix will take the machine parts purchased from Cam's inventory on July 14, free from Safe's security interest which was perfected on July 12.

Unofficial Answers

VII. Property

A. Real and Personal Property

M89

Answer 3 (10 points)

a. Ash, Bale, and Rangel will be personally liable to Vista for the deficiency resulting from the foreclosure sale because they became the principal debtors when they assumed the mortgage. Park will remain liable for the deficiency. Although Vista consented to the assumption of the mortgage by Ash, Bale, and Rangel, such assumption does not relieve Park from its obligation to Vista unless Park obtains a release from Vista or there is a novation.

b. The assertion that the sublet from Wein to Nord is void because Ash, Bale, and Rangel must consent to the sublet is incorrect. Unless the lease provides otherwise, a tenant may sublet the premises without the landlord's consent. Since the lease was silent regarding Wein's right to sublet, Wein may sublet to Nord without the consent of Ash, Bale, and Rangel.

The assertion that if the sublet was not void Ash, Bale, and Rangel have the right to hold either Wein or Nord liable for payment of rent is incorrect. In a sublease, the sublessee/subtenant (Nord) has no obligation to pay rent to the landlord (Ash, Bale, and Rangel).

The subtenant (Nord) is liable to the tenant (Wein), but the tenant (Wein) remains solely liable to the landlord (Ash, Bale, and Rangel) for the rent stipulated in the lease.

c. Ash's inter vivos transfer of his $\frac{1}{3}$ interest in the office building to his spouse on April 4, 1989 resulted in his spouse obtaining a $\frac{1}{3}$ interest in the office building as a tenant in common. Ash's wife did not become a joint tenant with Bale and Rangel because the transfer of a joint tenant's interest to an outside party destroys the joint tenancy nature of the particular interest transferred. Bale and Rangel will remain as joint tenants with each other.

As of April 21, 1989, the office building was owned by Ash's spouse who had a $\frac{1}{3}$ interest as tenant in common and Bale who had a $\frac{2}{3}$ interest as tenant in common.

Ash's death on April 20, 1989 will have no effect on the ownership of the office building because Ash had already transferred all of his interest to his wife on April 4, 1989.

Rangel's death on April 20, 1989 resulted in his interest being acquired by Bale because of the right of survivorship feature in a joint tenancy. Because there are no surviving joint tenants, Bale will become a tenant in common who owns $\frac{2}{3}$ of the office building. Ash's spouse will not acquire any additional interest due to

Rangel's death because she was a tenant in common with Rangel.

C. Fire and Casualty Insurance

N88

Answer 2 (10 points)

Starr's first assertion, that Birk has breached the contract with Starr because Birk failed to close the transaction and buy the warehouse at a price of \$200,000, is correct. An oral agreement modifying an enforceable existing contract is not enforceable if the modification is within the statute of frauds. A contract for the sale of real estate or a modification of such a contract falls within the provisions of the statute of frauds and therefore a writing signed by the party to be charged is required. The fact that Birk sent a signed memo to Starr is not effective because it was not signed by Starr. Furthermore, the agreement to reduce the purchase price to \$190,000 is not enforceable because Birk did not give any consideration for the modification. Birk had a pre-existing obligation to purchase the warehouse for \$200,000 and gave no new consideration for the modification of the price. The fact that Birk may have acted in good faith as a result of the decline in value of real estate and rise in interest rates will not be sufficient to make the oral agreement enforceable against Starr. Therefore, Birk's failure to pay \$200,000 as required by the July 1 contract constitutes a breach of that contract.

Starr's second assertion, that it has an insurable interest in the warehouse covered by the Pica policy, is correct. To constitute an insurable interest the element of financial or economic loss to the insured must be present. Furthermore, the insurable interest must be present at the time of the loss but need not be present at the time the policy was issued. Under the facts of this case, Starr had an insurable interest on the date of the loss (October 30) since it owned the warehouse on that date. Whether Starr had an insurable interest on February 15 will not affect Starr's right to recover from Pica.

Starr's third assertion, that it has met the coinsurance requirement under Pica's policy is correct.

Starr's fourth assertion, that Starr is entitled to recover the entire \$80,000 from Pica is incorrect. Starr is only entitled to receive \$64,000 from Pica calculated as follows:

$$\frac{\$160,000 \text{ (Amount of Insurance Coverage with Pica)}}{\$200,000 \text{ (Total Amount of Insurance on Warehouse)}} \times \$80,000 \text{ (Amount to be Paid)} = \$64,000$$

Thus, Pica's liability is limited to the amount its policy bears to the total amount of insurance on the warehouse.

Uniform CPA Examination

November 1989

**Questions and
Unofficial Answers**

NOVEMBER 1989

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WRITE YOUR 7-DIGIT CANDIDATE
NUMBER HERE. ONE DIGIT PER BOX.

EXAMINATION IN ACCOUNTING PRACTICE — PART I

November 1, 1989; 1:30 P.M. to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	Point Value	Estimated Minutes	
		Minimum	Maximum
No. 1	10	45	55
No. 2	10	45	55
No. 3	10	45	55
No. 4	10	45	55
No. 5	10	40	50
Totals	50	220	270

INSTRUCTIONS TO CANDIDATES

FAILURE TO FOLLOW THESE INSTRUCTIONS MAY HAVE AN ADVERSE EFFECT ON YOUR EXAMINATION GRADE

- You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.
- Answer **all** objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since objective items are computer-graded, your comments and calculations associated with them are not considered. Be certain that you have entered your answers on the objective answer sheet before the examination time is up. **THE OBJECTIVE PORTION OF YOUR EXAMINATION WILL NOT BE GRADED IF YOU FAIL TO RECORD YOUR ANSWERS ON THE OBJECTIVE ANSWER SHEET.**
- Support **all** problem-type answers with properly labeled and legible calculations that can be identified as sources of amounts in formal schedules, entries, worksheets, or other answers, to show how your final answer was derived. Computation sheets should identify the question to which they relate, be placed immediately following the answer to that question, and be numbered in sequence with the other pages. Failure to enclose supporting calculations may result in loss of grading points because it may be impossible to determine how your amounts were computed.
- For Question Number 4 be sure to include the completed tear-out worksheet in the proper sequence with other answer sheets.
- A CPA is continually confronted with the necessity of expressing opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.
- WRITE YOUR 7-DIGIT CANDIDATE NUMBER IN THE SPACE PROVIDED AT THE UPPER RIGHT HAND CORNER OF THIS PAGE.**
- YOU MUST HAND IN YOUR EXAMINATION BOOKLET AND ANSWER PAPERS BEFORE LEAVING THE EXAMINATION ROOM. YOUR EXAMINATION WILL NOT BE GRADED UNLESS YOUR EXAMINATION BOOKLET AND ANSWER PAPERS ARE HANDED IN.**
- IF YOU WANT YOUR EXAMINATION BOOKLET MAILED TO YOU, WRITE YOUR NAME AND ADDRESS IN THE SPACE PROVIDED ON THE BACK COVER PAGE AND PLACE 45 CENTS POSTAGE IN THE SPACE PROVIDED, UNLESS OTHERWISE INSTRUCTED. EXAMINATION BOOKLETS WILL BE DISTRIBUTED NO SOONER THAN THE DAY FOLLOWING THE ADMINISTRATION OF THIS EXAMINATION.**

*Prepared by the Board of Examiners of the American Institute of Certified Public Accountants
and adopted by the examining boards of all states, the District of Columbia, Guam,
Puerto Rico, and the Virgin Islands of the United States.*

Instructions

Questions Number 1, 2, and 3 each consist of 20 multiple choice items. Select the **best** answer for each of the items relating to a **variety of financial accounting problems**. Use a soft pencil, preferably No. 2, to blacken the appropriate circle on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on the total number of correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

97. Gross billings for merchandise sold by Baker Company to its customers last year amounted to \$5,260,000; sales returns and allowances reduced the amounts owed by \$160,000. Net sales were

- a. \$4,800,000
- b. \$5,100,000
- c. \$5,200,000
- d. \$5,260,000

Answer Sheet

97. (a) ☒ (c) ☐ (d) ☐

Number 1 (Estimated time — 45 to 55 minutes)

Items 1 and 2 are based on the following:

Coffey Corp.'s trial balance of income statement accounts for the year ended December 31, 1988 was as follows:

	<u>Debit</u>	<u>Credit</u>
Net sales		\$1,600,000
Cost of goods sold	\$ 960,000	
Selling expenses	235,000	
Administrative expenses	150,000	
Interest expense	25,000	
Adjustment due to accounting change in depreciation method	40,000	
Gain on debt extinguishment		10,000
Totals	<u>\$1,410,000</u>	<u>\$1,610,000</u>

Coffey's income tax rate is 30%. Coffey prepares a multiple-step income statement for 1988.

1. Income from operations before income tax is
 - a. \$190,000
 - b. \$200,000
 - c. \$230,000
 - d. \$240,000

2. Net income is
 - a. \$140,000
 - b. \$161,000
 - c. \$168,000
 - d. \$200,000

3. Jay Company acquired a wholly-owned foreign subsidiary on January 1, 1988. The stockholders' equity section of the December 31, 1988 consolidated balance sheet follows:

Common stock	\$ 500,000
Additional paid-in capital	200,000
Retained earnings	900,000
	<u>1,600,000</u>
Less: Contra account	600,000
Total stockholders' equity	<u>\$1,000,000</u>

The contra account balance appropriately represents adjustments in translating the foreign subsidiary's financial statements into U.S. dollars.

The consolidated income statement for 1988 included the excess of cost of investments in marketable equity securities over their market values, which is considered temporary, as follows:

Noncurrent investments	\$200,000
Current investments	\$100,000

The correct amounts for retained earnings and the contra accounts in the consolidated statement of stockholders' equity for the year ended December 31, 1988 are

	<u>Retained earnings</u>	<u>Contra accounts</u>
a.	\$ 900,000	\$600,000
b.	\$1,000,000	\$700,000
c.	\$1,100,000	\$800,000
d.	\$1,200,000	\$900,000

4. Chester Corp. was a development stage enterprise from its inception on September 1, 1987 to December 31, 1988. The following information was taken from Chester's accounting records for the above period:

Net sales	\$1,350,000
Cost of sales	1,000,000
Selling, general, and administrative expenses	400,000
Research and development costs	300,000
Interest expense	100,000

For the period September 1, 1987 to December 31, 1988, what amount should Chester report as net loss?

- a. \$ 50,000
- b. \$150,000
- c. \$350,000
- d. \$450,000

Items 5 through 8 are based on the following:

The separate condensed balance sheets and income statements of Dean Corp. and its wholly-owned subsidiary, Kay Corp., are as follows:

BALANCE SHEETS
December 31, 1988

	<i>Dean</i>	<i>Kay</i>
<i>Assets</i>		
Current assets	\$ 430,000	\$300,000
Property, plant, and equipment (net)	360,000	400,000
Investment in Subsidiary (equity method)	650,000	—
Total assets	<u>\$1,440,000</u>	<u>\$700,000</u>
<i>Liabilities and Stockholders' Equity</i>		
Current liabilities	\$ 130,000	\$140,000
Stockholders' equity		
Common stock (\$10 par)	320,000	80,000
Additional paid-in capital	370,000	200,000
Retained earnings	620,000	280,000
Total stockholders' equity	<u>1,310,000</u>	<u>560,000</u>
Total liabilities and stockholders' equity	<u>\$1,440,000</u>	<u>\$700,000</u>

INCOME STATEMENTS
For the Year Ended December 31, 1988

	<i>Dean</i>	<i>Kay</i>
Sales	\$1,100,000	\$600,000
Cost of goods sold	770,000	400,000
Gross profit	330,000	200,000
Other operating expenses	120,000	100,000
Operating income	210,000	100,000
Equity in earnings of Kay	60,000	—
Income before federal income taxes	270,000	100,000
Provision for federal income taxes	70,000	30,000
Net income	<u>\$ 200,000</u>	<u>\$ 70,000</u>

Additional information:

- On January 1, 1988, Dean purchased all of Kay's \$10 par, voting common stock for \$600,000. On that date, the fair value of Kay's assets and liabilities equaled their carrying amount of \$660,000 and \$160,000, respectively. Dean's policy is to amortize intangibles over a 10-year period, unless a definite life is ascertainable.
- During 1988, Dean and Kay paid cash dividends of \$50,000 and \$10,000, respectively. For tax purposes, Dean receives the 100% exclusion for dividends received from Kay.
- There were no intercompany transactions except for Dean's receipt of dividends from Kay, and Dean's recording of its share of Kay's earnings.
- On June 30, 1988, Dean sold 2,000 shares of its common stock for \$17 per share. There were no other changes in either Dean's or Kay's common stock during 1988.

5. In Dean's 1988 consolidated income statement, what amount should be reported as consolidated net income?

- a. \$140,000
- b. \$200,000
- c. \$210,000
- d. \$270,000

6. In Dean's December 31, 1988 consolidated balance sheet, what amount should be reported as total consolidated assets?

- a. \$2,140,000
- b. \$1,580,000
- c. \$1,490,000
- d. \$1,440,000

7. In Dean's December 31, 1988 consolidated balance sheet, what amount should be reported as total retained earnings?

- a. \$620,000
- b. \$680,000
- c. \$690,000
- d. \$900,000

8. In Dean's 1988 consolidated income statement, what amount should be reported for amortization of goodwill?

- a. \$0
- b. \$ 6,000
- c. \$ 9,000
- d. \$10,000

Examination Questions — November 1989

9. Magnolia, Inc.'s December 31, 1988 unadjusted current assets section and stockholders' equity section are as follows:

Current Assets:

Cash	\$ 30,000
Investments in marketable equity securities (including \$150,000 of Magnolia, Inc. common stock)	200,000
Trade accounts receivable	170,000
Inventories	74,000
Total	\$ 474,000

Stockholders' Equity:

Common stock	\$1,112,000
Retained earnings (deficit)	(112,000)
Total	\$1,000,000

The investments and inventories are reported at their costs which approximate market values.

In its 1988 statement of changes in stockholders' equity, Magnolia's total amount of equity at December 31, 1988 is

- a. \$ 850,000
- b. \$ 962,000
- c. \$1,000,000
- d. \$1,112,000

Items 10 and 11 are based on the following:

On December 31, 1988, Saxe Corporation was merged into Poe Corporation. In the business combination, Poe issued 200,000 shares of its \$10 par common stock, with a market price of \$18 a share, for all of Saxe's common stock. The stockholders' equity section of each company's balance sheet immediately before the combination was:

	<i>Poe</i>	<i>Saxe</i>
Common stock	\$3,000,000	\$1,500,000
Additional paid-in capital	1,300,000	150,000
Retained earnings	2,500,000	850,000
	<u>\$6,800,000</u>	<u>\$2,500,000</u>

10. Assume that the merger qualifies for treatment as a purchase. In the December 31, 1988 consolidated balance sheet, additional paid-in capital should be reported at

- a. \$ 950,000
- b. \$1,300,000
- c. \$1,450,000
- d. \$2,900,000

11. Assume that the merger qualifies for treatment as a pooling of interests. In the December 31, 1988 consolidated balance sheet, additional paid-in capital should be reported at

- a. \$ 950,000
- b. \$1,300,000
- c. \$1,450,000
- d. \$2,900,000

12. Tobin Corp. incurred \$160,000 of research and development costs to develop a product for which a patent was granted on January 2, 1983. Legal fees and other costs associated with registration of the patent totaled \$30,000. On March 31, 1988, Tobin paid \$45,000 for legal fees in a successful defense of the patent. The total amount capitalized for this patent through March 31, 1988 should be

- a. \$ 75,000
- b. \$190,000
- c. \$205,000
- d. \$235,000

13. Mark Co. bought a franchise from Fred Co. on January 1, 1988 for \$204,000. An independent consultant retained by Mark estimated that the remaining useful life of the franchise was 50 years. Its unamortized cost on Fred's books at January 1, 1988 was \$68,000. Mark has decided to amortize the franchise over the maximum period allowed. What amount should be amortized for the year ended December 31, 1988?

- a. \$5,100
- b. \$4,080
- c. \$4,000
- d. \$1,700

14. Pam, Inc. has \$1,000,000 of notes payable due June 15, 1989. At the financial statement date of December 31, 1988, Pam signed an agreement to borrow up to \$1,000,000 to refinance the notes payable on a long-term basis. The financing agreement called for borrowings not to exceed 80% of the value of the collateral Pam was providing. At the date of issue of the December 31, 1988 financial statements, the value of the collateral was \$1,200,000 and was not expected to fall below this amount during 1989. In its December 31, 1988 balance sheet, Pam should classify notes payable as

	<u>Short-term obligations</u>	<u>Long-term obligations</u>
a.	\$0	\$1,000,000
b.	\$ 40,000	\$ 960,000
c.	\$ 200,000	\$ 800,000
d.	\$1,000,000	\$0

Accounting Practice — Part I

15. Cey, Inc. determined that it has an obligation relating to employees' rights to receive compensation for future absences attributable to employees' services already rendered. The obligation relates to rights that accumulate and vest. Payment of this compensation is probable. The amounts of Cey's obligations at December 31, 1988 are reasonably estimated as follows:

Vacation pay	\$90,000
Sick pay	60,000

In Cey's December 31, 1988 balance sheet, what amount should be reported as a liability for compensated absences?

- \$0
- \$ 60,000
- \$ 90,000
- \$150,000

16. Fay Corp. pays its outside salespersons fixed monthly salaries and commissions on net sales. Sales commissions are computed and paid on a monthly basis (in the month following the month of sale), and the fixed salaries are treated as advances against commissions. However, if the fixed salaries for salespersons exceed their sales commissions earned for a month, such excess is not charged back to them. Pertinent data for the month of March 1988 for the three salespersons are as follows:

<i>Salesperson</i>	<i>Fixed salary</i>	<i>Net sales</i>	<i>Commission rate</i>
A	\$10,000	\$ 200,000	4%
B	14,000	400,000	6%
C	18,000	600,000	6%
Totals	<u>\$42,000</u>	<u>\$1,200,000</u>	

What amount should Fay accrue for sales commissions payable at March 31, 1988?

- \$70,000
- \$68,000
- \$28,000
- \$26,000

17. On December 31, 1988, Wall Corp. issued \$100,000 maturity value, 10% bonds for \$100,000 cash. The bonds are dated December 31, 1988 and mature on December 31, 1998. Interest will be paid semiannually on June 30 and December 31. In Wall's September 30, 1989 balance sheet, the amount of accrued interest expense should be

- \$ 2,500
- \$ 5,000
- \$ 7,500
- \$10,000

18. Jerry Corp., a company whose stock is publicly traded, provides a noncontributory defined benefit pension plan for its employees. The company's actuary has provided the following information for the year ended December 31, 1988:

Projected benefit obligation	\$400,000
Accumulated benefit obligation	350,000
Plan assets (fair value)	410,000
Service cost	120,000
Interest on projected benefit obligation	12,000
Amortization of unrecognized prior service cost	30,000
Expected and actual return on plan assets	41,000

The market-related asset value equals the fair value of plan assets. Prior contributions to the defined benefit pension plan equaled the amount of net periodic pension cost accrued for the previous year end. No contributions have been made for 1988 pension cost. In its December 31, 1988 balance sheet, Jerry should report an accrued pension cost of

- \$203,000
- \$162,000
- \$121,000
- \$109,000

19. A state requires quarterly sales tax returns to be filed with the sales tax bureau by the 20th day following the end of the calendar quarter. However, the state further requires that sales taxes collected be remitted to the sales tax bureau by the 20th day of the month following any month such collections exceed \$500. These payments can be taken as credits on the quarterly sales tax return.

Taft Corp. operates a retail hardware store. All items are sold subject to a 6% state sales tax, which Taft collects and records as sales revenue. The sales taxes paid by Taft are charged against sales revenue. Taft pays the sales taxes when they are due.

Following is a monthly summary appearing in Taft's first quarter 1989 sales revenue account:

	<i>Debit</i>	<i>Credit</i>
January	\$ —	\$10,600
February	600	7,420
March	—	9,540
	<u>\$600</u>	<u>\$27,560</u>

In its financial statements for the quarter ended March 31, 1989, Taft's sales revenue and sales taxes payable would be

	<i>Sales revenue</i>	<i>Sales taxes payable</i>
a.	\$27,560	\$1,560
b.	\$26,960	\$ 600
c.	\$26,000	\$1,560
d.	\$26,000	\$ 960

20. On January 1, 1988, Mill Corp. leased a machine to Ott Corp. for a five year term at an annual rental of \$50,000. The lease is an operating lease. At the inception of the lease Mill received \$100,000, covering the first year's rent of \$50,000 and a security deposit of \$50,000. This deposit will not be returned to Ott upon expiration of the lease, but will instead be applied to payment of rent for the last year of the lease. Mill properly reported rental revenue of \$100,000 in its 1988 income tax return. Mill's tax rate was 30%. In Mill's December 31, 1988 balance sheet, what portion of the \$100,000 should be reported as a liability?

- a. \$50,000
- b. \$40,000
- c. \$35,000
- d. \$28,000

Number 2 (Estimated time — 45 to 55 minutes)

21. Grey operates as a retail furrier. Some customers pick out furs and place deposits with Grey to set the furs aside for future delivery. Grey records the cash receipts on these transactions as lay-away plan sales. However, title to the fur passes to the customer only when the full sales price is received by Grey. The average gross margin on the furs is 75% of sales. The following pertinent data were taken from Grey's December 31, 1988 unadjusted trial balance:

Regular sales	\$2,500,000
Lay-away plan sales	\$1,000,000
Deposits from customers	\$0

An analysis of the lay-away plan sales revealed that \$600,000 was received in full payment for furs delivered to customers during 1988. In Grey's December 31, 1988 balance sheet, deposits from customers would be

- a. \$1,000,000
- b. \$ 750,000
- c. \$ 600,000
- d. \$ 400,000

22. On December 30, 1987, Bliss Corp. leased equipment under a capital lease for a period of 12 years, contracting to pay \$100,000 annual rent on December 31, 1987 and on December 31 for each of the next 9 years. The capital lease liability was appropriately recorded at \$681,600 on December 30, 1987 before the first payment. The useful life of the equipment coincided with the lease term. The interest rate implicit in the lease is 10%. In recording the December 31, 1988 payment, Bliss should reduce the capital lease liability by

- a. \$68,160
- b. \$58,160
- c. \$56,800
- d. \$41,840

23. Karr Co. began operations on January 1, 1988 and appropriately uses the installment method of accounting. The following information pertains to Karr's operations for 1988:

Installment sales	\$800,000
Cost of installment sales	480,000
General and administrative expenses	80,000
Collections on installment sales	300,000

The balance in the deferred gross profit account at December 31, 1988 should be

- a. \$120,000
- b. \$150,000
- c. \$200,000
- d. \$320,000

24. Frey Corp., a construction company, appropriately uses the completed contract method of accounting for income tax purposes. However, Frey uses the percentage-of-completion accounting method for financial statement purposes. Pertinent data at December 31, 1988, the close of Frey's first year of operations, are:

<i>Date contract began</i>	<i>Estimated completion date</i>	<i>Income recognized in 1988 on each contract</i>
3/1/88	9/1/89	\$600,000
6/1/88	12/1/89	300,000
9/1/88	3/1/90	200,000
12/1/88	6/1/90	100,000

Frey's enacted income tax rates are 30% for 1988, 25% for 1989 and 20% for 1990. Frey elected early application of FASB Statement No. 96, *Accounting for Income Taxes*, in its financial statements for the year ended December 31, 1988. What amount should be included in the deferred income tax liability at December 31, 1988 for these transactions?

- a. \$360,000
- b. \$330,000
- c. \$285,000
- d. \$240,000

25. On January 1, 1989, Pine Corp. sold 200 of its 8%, \$1,000 bonds at 97 plus accrued interest. The bonds are dated October 1, 1988 and mature on October 1, 1998. Interest is payable semiannually on April 1 and October 1. Accrued interest for the period October 1, 1988 to January 1, 1989 amounted to \$4,000. On January 1, 1989, Pine should report bonds payable, net of discount, at

- a. \$196,000
- b. \$194,150
- c. \$194,000
- d. \$190,150

Accounting Practice — Part I

26. On December 2, 1988, Huff Corp. received a condemnation award of \$450,000 as compensation for the forced sale of land purchased five years earlier for \$300,000. The gain was not reported as taxable income on its income tax return for the year ended December 31, 1988, because Huff elected to replace the land within the allowed replacement period for at least \$450,000. Huff has an income tax rate of 25% for 1988, and there is an enacted rate of 30% for years ending after 1988. There were no other temporary differences. Huff elected early application of FASB Statement No. 96, *Accounting for Income Taxes*. In its December 31, 1988 balance sheet, Huff should report a deferred income tax liability of

- a. \$135,000
- b. \$ 45,000
- c. \$ 37,500
- d. \$0

27. On December 30, 1988, Haber Co. leased a new machine from Gregg Corp. The following data relate to the lease transaction at the inception of the lease:

Lease term	10 years
Annual rental payable at the end of each lease year	\$100,000
Useful life of machine	12 years
Implicit interest rate	10%
Present value of an annuity of 1 in advance for 10 periods at 10%	6.76
Present value of annuity of 1 in arrears for 10 periods at 10%	6.15
Fair value of the machine	\$700,000

The lease has no renewal option, and the possession of the machine reverts to Gregg when the lease terminates. At the inception of the lease, Haber should record a lease liability of

- a. \$0
- b. \$615,000
- c. \$630,000
- d. \$676,000

28. On May 1, Kreal Corp. issued \$1,000,000, 20-year, 10% bonds for \$1,075,000. Each \$1,000 bond had a detachable warrant eligible for the purchase of one share of Kreal's \$50 par value common stock for \$60. Immediately after the bonds were issued, Kreal's securities had the following market values:

10% bond without warrant	\$1,050
Warrant	25
Common stock, \$50 par value	65

What amount of the bond issue proceeds should Kreal record as an increase in stockholders' equity?

- a. \$50,000
- b. \$25,000
- c. \$ 5,000
- d. \$0

29. On January 1, 1989, Carrow, Inc. issued its 10% bonds in the face amount of \$1,000,000 that mature on January 1, 1999. The bonds were issued for \$886,000 to yield 12%, resulting in bond discount of \$114,000. Carrow uses the interest method of amortizing bond discount. Interest is payable July 1 and January 1. For the six months ended June 30, 1989, Carrow should report bond interest expense at

- a. \$56,840
- b. \$55,700
- c. \$53,160
- d. \$50,000

30. Faber, Inc. had outstanding 10%, \$1,000,000 face amount convertible bonds maturing on December 31, 1993, on which interest is paid June 30 and December 31. After amortization through June 30, 1989, the unamortized balance in the bond discount account was \$30,000. On that date, all of these bonds were converted into 40,000 shares of \$20 par value common stock. Faber incurred expenses of \$10,000 in connection with the conversion. Recording the conversion by the book value (carrying amount) method, Faber should credit additional paid-in capital for

- a. \$160,000
- b. \$170,000
- c. \$180,000
- d. \$230,000

31. On February 1, 1986, Davis Corp. issued 12%, \$1,000,000 face amount, 10-year bonds for \$1,117,000. Davis reacquired all of these bonds at 102, plus accrued interest, on May 1, 1989 and retired them. Unamortized bond premium on that date was \$78,000. Before income taxes, what was Davis' gain on the bond retirement?

- a. \$97,000
- b. \$58,000
- c. \$39,000
- d. \$19,000

32. On November 10, 1988, a Garry Corp. truck was in an accident with an auto driven by Dacey. On January 10, 1989, Garry received notice of a lawsuit seeking \$800,000 in damages for personal injuries suffered by Dacey. Garry Corp.'s counsel believes it is reasonably possible that Dacey will be awarded an estimated amount in the range between \$250,000 and \$500,000, and that \$400,000 is a better estimate of potential liability than any other amount. Garry's accounting year ends on December 31, and the 1988 financial statements were issued on March 6, 1989. What amount of loss should Garry accrue at December 31, 1988?

- a. \$0
- b. \$250,000
- c. \$400,000
- d. \$500,000

Examination Questions — November 1989

33. In packages of its products, Curran Co. includes coupons that may be presented at retail stores to obtain discounts on other Curran products. Retailers are reimbursed for the face amount of coupons redeemed plus 10% of that amount for handling costs. Curran honors requests for coupon redemption by retailers up to three months after the consumer expiration date. Curran estimates that 70% of all coupons issued will ultimately be redeemed. Information relating to coupons issued by Curran during 1988 is as follows:

Consumer expiration date	12/31/88
Total face amount of coupons issued	\$600,000
Total payments to retailers as of 12/31/88	220,000

What amount should Curran report as a liability for unredeemed coupons at December 31, 1988?

- a. \$0
- b. \$200,000
- c. \$242,000
- d. \$308,000

34. Peg Co. leased equipment from Howe Corp. on July 1, 1988 for an eight-year period expiring June 30, 1996. Equal payments under the lease are \$600,000 and are due on July 1 of each year. The first payment was made on July 1, 1988. The rate of interest contemplated by Peg and Howe is 10%. The cash selling price of the equipment is \$3,520,000, and the cost of the equipment on Howe's accounting records is \$2,800,000. The lease is appropriately recorded as a sales-type lease. What is the amount of profit on the sale and interest revenue that Howe should record for the year ended December 31, 1988?

	<i>Profit on sale</i>	<i>Interest revenue</i>
a.	\$720,000	\$176,000
b.	\$720,000	\$146,000
c.	\$ 45,000	\$176,000
d.	\$ 45,000	\$146,000

35. On October 1, 1988, Price Corp., a real estate developer, sold land to Greene Co. for \$5,000,000. Greene paid \$600,000 cash and signed a 10 year \$4,400,000 note bearing interest at 12%. The carrying amount of the land was \$4,000,000 on date of sale. The note was payable in forty quarterly principal installments of \$110,000 beginning January 2, 1989. Price appropriately accounts for the sale under the cost recovery method. On January 2, 1989, Greene paid the first principal installment of \$110,000 and interest of \$132,000. For the year ended December 31, 1988, what total amount of income should Price recognize from the land sale and financing?

- a. \$0
- b. \$120,000
- c. \$132,000
- d. \$252,000

36. John Tracey, M.D., keeps his accounting records on the cash basis. During 1988, Dr. Tracey collected \$150,000 in fees from his patients. At December 31, 1987, Dr. Tracey had accounts receivable of \$20,000. At December 31, 1988, Dr. Tracey had accounts receivable of \$35,000 and unearned fees of \$5,000. On the accrual basis, how much was Dr. Tracey's patient service revenue for 1988?

- a. \$130,000
- b. \$160,000
- c. \$165,000
- d. \$170,000

37. On January 1, 1988, Dyer Co. acquired as a long-term investment a 20% common stock interest in Eason Co. Dyer paid \$700,000 for this investment when the fair value of Eason's net assets was \$3,500,000. Dyer can exercise significant influence over Eason's operating and financial policies. For the year ended December 31, 1988, Eason reported net income of \$400,000 and declared and paid cash dividends of \$160,000. How much revenue from this investment should Dyer report for 1988?

- a. \$ 32,000
- b. \$ 48,000
- c. \$ 80,000
- d. \$112,000

38. On January 1, 1988, Jaffe Co. leased a machine to Pender Co. for ten years, with \$10,000 payments due at the beginning of each year effective at the inception of the lease. The machine cost Jaffe \$55,000. The lease is appropriately accounted for as a sales-type lease by Jaffe. The present value of the ten rent payments over the lease term discounted appropriately at 10% was \$67,600. The estimated salvage value of the machine at the end of ten years is equal to the disposal costs. How much interest revenue should Jaffe record from the lease for the year ended December 31, 1988?

- a. \$5,500
- b. \$5,760
- c. \$6,760
- d. \$7,020

39. Albert Co. acquired 4,000 shares of Nolan, Inc. common stock on October 20, 1986 for \$66,000. On November 30, 1988, Nolan distributed a 10% common stock dividend when the market price of the stock was \$25 per share. On December 20, 1988, Albert sold 400 shares of its Nolan stock for \$10,600. For the year ended December 31, 1988, how much should Albert report as dividend revenue?

- a. \$10,600
- b. \$10,000
- c. \$ 4,600
- d. \$0

Accounting Practice — Part I

40. On January 2, 1988, Osborn Co. assigned its patent to Aile for royalties of 10% of patent related sales. On the same date, Osborn received a \$40,000 advance to be applied against royalties for 1988 sales. Royalties are payable every six months. Aile reported the following sales:

<u>Six months ended</u>	<u>Amount</u>
June 30, 1988	\$150,000
December 31, 1988	200,000

How much royalty revenue should Osborn report in its 1988 income statement?

- a. \$75,000
- b. \$60,000
- c. \$40,000
- d. \$35,000

Number 3 (Estimated time — 45 to 55 minutes)

41. On January 3, 1986, Falk Co. purchased 500 shares of Milo Corp. common stock for \$36,000. On December 2, 1988, Falk received 500 stock rights from Milo. Each right entitles the holder to acquire one share of stock for \$85. The market price of Milo's stock was \$100 a share immediately before the rights were issued, and \$90 a share immediately after the rights were issued. Falk sold its rights on December 3, 1988 for \$10 a right. Falk's gain from the sale of the rights is

- a. \$0
- b. \$1,000
- c. \$1,400
- d. \$5,000

42. On December 1, 1988, Barr Company leased office space for five years at a monthly rental of \$60,000. On that date, Barr paid the lessor the following amounts:

First month's rent	\$ 60,000
Last month's rent	60,000
Security deposit (refundable at lease expiration)	80,000
Installation of new walls and offices	360,000

Barr's December 1988 expense relating to its use of this office space is

- a. \$ 60,000
- b. \$ 66,000
- c. \$126,000
- d. \$200,000

43. On April 8, 1987, Day Corp. purchased merchandise from an unaffiliated foreign company for 10,000 units of the foreign company's local currency. Day paid the bill in full on March 1, 1988 when the spot rate was \$.45. The spot rate was \$.60 on April 8, 1987 and was \$.55 on December 31, 1987. For the year ended December 31, 1988, Day should report a transaction gain of

- a. \$1,500
- b. \$1,000
- c. \$ 500
- d. \$0

44. On January 2, 1987, Troast Co. purchased as a long-term investment 10,000 shares of Lawton Corp. common stock for \$70 per share, which represents a 1% interest. On December 31, 1987, the market price of the stock was \$75 per share. On December 20, 1988, Troast needed additional cash for operations and sold all 10,000 shares of Lawton's stock for \$100 per share. Troast's income tax rate was 30% for 1988. For the year ended December 31, 1988, Troast should report on its income statement a gain on disposal of

- a. \$300,000
- b. \$250,000
- c. \$210,000
- d. \$175,000

45. The following data were available from Mith Co.'s records on December 31, 1988:

Finished goods inventory, 1/1/88	\$120,000
Finished goods inventory, 12/31/88	110,000
Cost of goods manufactured	520,000
Loss on sale of plant equipment	50,000

The cost of goods sold for 1988 was

- a. \$510,000
- b. \$520,000
- c. \$530,000
- d. \$580,000

46. On January 1, 1988, Dart, Inc. entered into an agreement to sell the assets and product line of its Jay Division, considered a segment of the business. The sale was consummated on December 31, 1988 and resulted in a gain on disposition of \$400,000. The division's operations resulted in losses before income tax of \$225,000 in 1988 and \$125,000 in 1987. Dart's income tax rate is 30% for both years. In a comparative statement of income for 1988 and 1987, as components under the caption Discontinued Operations, Dart should report a gain (loss) amounting to

	<u>1988</u>	<u>1987</u>
a.	\$122,500	(\$87,500)
b.	\$122,500	\$0
c.	(\$157,500)	(\$87,500)
d.	(\$157,500)	\$0

Items 47 and 48 are based on the following:

Bee Corp. prepared the following reconciliation between book income and taxable income for the year ended December 31, 1988:

Pretax accounting income	\$500,000
Taxable income	<u>300,000</u>
Difference	<u>\$200,000</u>
Differences:	
Interest on municipal bonds	\$ 50,000
Lower depreciation per financial statements	<u>150,000</u>
Total differences	<u>\$200,000</u>

Bee elected early application of FASB Statement No. 96, *Accounting for Income Taxes*, in its financial statements for the year ended December 31, 1988.

Bee's effective income tax rate for 1988 is 30%. The depreciation difference will reverse equally over the next three years at enacted tax rates as follows:

<u>Years</u>	<u>Tax rates</u>
1989	30%
1990	25%
1991	25%

47. In Bee's 1988 income statement, the current portion of its provision for income taxes should be

- a. \$150,000
- b. \$125,000
- c. \$ 90,000
- d. \$ 75,000

48. In Bee's 1988 income statement, the deferred portion of its provision for income taxes should be

- a. \$60,000
- b. \$50,000
- c. \$45,000
- d. \$40,000

49. Harper Co. incurred an apparently permanent inventory loss from market decline of \$840,000 during June 1989. What amount of the inventory loss should be recognized in Harper's quarterly income statement for the three months ended June 30, 1989?

- a. \$210,000
- b. \$280,000
- c. \$420,000
- d. \$840,000

50. Lowe Corp. had the following gains, net of applicable taxes, during 1988:

Foreign currency transaction gain due to major devaluation	\$175,000
Gain from early extinguishment of Lowe's debt	250,000

What amount should Lowe report as extraordinary gains in its 1988 income statement?

- a. \$425,000
- b. \$250,000
- c. \$175,000
- d. \$0

51. On December 31, 1988, Kerr, Inc. appropriately changed its inventory valuation method to FIFO cost from weighted-average cost for financial statement and income tax purposes. The change will result in a \$700,000 increase in the beginning inventory at January 1, 1988. Assume a 30% income tax rate. The cumulative effect of this accounting change reported for the year ended December 31, 1988 is

- a. \$0
- b. \$210,000
- c. \$490,000
- d. \$700,000

52. On January 1, 1987, Aker Corp. acquired a machine at a cost of \$200,000. It was to be depreciated on the straight line method over a five-year period with no residual value. Because of a bookkeeping error, no depreciation was recognized in Aker's 1987 financial statements. The oversight was discovered during the preparation of Aker's 1988 financial statements. Depreciation expense on this machine for 1988 should be

- a. \$0
- b. \$40,000
- c. \$50,000
- d. \$80,000

53. On January 1, 1987, West Co. entered into a ten-year lease for a manufacturing plant. The annual minimum lease payments are \$100,000. In the notes to the December 31, 1988 financial statements, what amounts of subsequent years' lease payments should be disclosed?

	<u>Amount for appropriate required period</u>	<u>Aggregate amount for the period thereafter</u>
a.	\$100,000	\$0
b.	\$300,000	\$500,000
c.	\$500,000	\$300,000
d.	\$500,000	\$0

Accounting Practice — Part I

54. Jones Corp.'s capital structure was as follows:

	<i>December 31</i>	
	<i>1988</i>	<i>1987</i>
Outstanding shares of stock:		
Common	110,000	110,000
Convertible preferred	10,000	10,000
8% convertible bonds	\$1,000,000	\$1,000,000

During 1988, Jones paid dividends of \$3.00 per share on its preferred stock. The preferred shares are convertible into 20,000 shares of common stock and are considered common stock equivalents. The 8% bonds are convertible into 30,000 shares of common stock but are not considered common stock equivalents. Net income for 1988 is \$850,000. Assume that the income tax rate is 30%.

The fully diluted earnings per share for 1988 is

- a. \$5.48
- b. \$5.66
- c. \$5.81
- d. \$6.26

55. Selected data for two subsidiaries of Dunn Corp. taken from December 31, 1988 pre-closing trial balances are as follows:

	<i>Banks Co. Debit</i>	<i>Lamm Co. Credit</i>
Shipments to Banks	\$ —	\$150,000
Shipments from Lamm	200,000	—
Intercompany inventory profit on total shipments	—	50,000

Additional data relating to the December 31, 1988 inventory are as follows:

Inventory acquired from outside parties	\$175,000	\$250,000
Inventory acquired from Lamm	60,000	—

At December 31, 1988, the inventory reported on the combined balance sheet of the two subsidiaries should be

- a. \$425,000
- b. \$435,000
- c. \$470,000
- d. \$485,000

56. On January 1, 1988, Heath Corp. established an employee stock ownership plan (ESOP). Selected transactions relating to the ESOP during 1988 were as follows:

- On April 1, 1988, Heath contributed \$45,000 cash and 3,000 shares of its \$10 par value common stock to the ESOP. On this date, the market price of the stock was \$18 a share.
- On October 1, 1988, the ESOP borrowed \$100,000 from Union National Bank and acquired 6,000 shares of Heath's common stock in the open market at \$17 a share. The note is for one year, bears interest at 10%, and is guaranteed by Heath.
- On December 15, 1988, the ESOP distributed 8,000 shares of Heath's common stock to employees of Heath in accordance with the plan formula. On this date, the market price of the stock was \$20 a share.

In its 1988 income statement, what amount should Heath report as compensation expense relating to the ESOP?

- a. \$ 99,000
- b. \$155,000
- c. \$199,000
- d. \$259,000

57. The following data pertain to Thorne Corp. for the calendar year 1988:

Net income	\$240,000
Dividends paid on common stock	120,000
Common stock outstanding (unchanged during year)	300,000 shares

The market price per share of Thorne's common stock at December 31, 1988 was \$12. The price-earnings ratio at December 31, 1988 was

- a. 9.6 to 1.
- b. 10.0 to 1.
- c. 15.0 to 1.
- d. 30.0 to 1.

58. John Holt owns 50% of the common stock of Brett Corp. Holt paid \$25,000 for this stock in 1983. At December 31, 1988, it was ascertained that Holt's 50% stock ownership in Brett had a current value of \$185,000. Brett's cumulative net income and cash dividends declared for the five years ended December 31, 1988 were \$300,000 and \$30,000 respectively. In Holt's personal statement of financial condition at December 31, 1988, what amount should be reported as his net investment in Brett?

- a. \$ 25,000
- b. \$160,000
- c. \$175,000
- d. \$185,000

Examination Questions — November 1989

59. Information with respect to Bruno Co.'s cost of goods sold for 1988 is as follows:

	<u>Historical cost</u>	<u>Units</u>
Inventory, 1/1/88	\$1,060,000	20,000
Production during 1988	5,580,000	90,000
	6,640,000	110,000
Inventory, 12/31/88	2,520,000	40,000
Cost of goods sold	<u>\$4,120,000</u>	<u>70,000</u>

Bruno estimates that the current cost per unit of inventory was \$58 at January 1, 1988 and \$72 at December 31, 1988. In Bruno's supplementary information restated into average current cost, the cost of goods sold for 1988 should be

- \$5,040,000
- \$4,550,000
- \$4,410,000
- \$4,060,000

60. In May 1985, Croft Co. filed suit against Walton, Inc. seeking \$950,000 damages for patent infringement. A court verdict in November 1988 awarded Croft \$750,000 in damages, but Walton's appeal is not expected to be decided before 1990. Croft's counsel believes it is probable that Croft will be successful against Walton for an estimated amount in the range between \$400,000 and \$550,000, with \$500,000 considered the most likely amount. What amount should Croft record as revenue from the lawsuit in the year ended December 31, 1988?

- \$750,000
- \$500,000
- \$400,000
- \$0

Number 4 (Estimated time — 45 to 55 minutes)

Nan Co.'s property, plant, and equipment and accumulated depreciation and amortization balances at December 31, 1987 are:

	<u>Cost</u>	<u>Accumulated Depreciation</u>
Land	\$ 275,000	—
Buildings	2,800,000	\$ 672,900
Machinery and equipment	1,380,000	367,500
Automobiles and trucks	210,000	114,326
Leasehold improvements	432,000	108,000
Totals	<u>\$5,097,000</u>	<u>\$1,262,726</u>

Additional information follows:

Depreciation and amortization methods and useful lives

Buildings — 150% declining balance; 25 years.
Machinery and equipment — straight-line; 10 years.
Automobiles and trucks — 150% declining balance;
five years, all acquired after 1985.

Leasehold improvements — straight-line.

Depreciation is computed to the nearest month.

Salvage values of depreciable assets are immaterial except for automobiles and trucks which have estimated salvage values equal to 15% of cost.

Other additional information

- Nan entered into a twelve-year operating lease starting January 1, 1985. The leasehold improvements were completed on December 31, 1984 and the facility was occupied on January 1, 1985.
- On January 6, 1988, Nan completed its self-construction of a building on its own land. Direct costs of construction were \$1,095,000. Construction of the building required 15,000 direct labor hours. Nan's construction department has an overhead allocation system for outside jobs based on an activity denominator of 100,000 direct labor hours, budgeted fixed costs of \$2,500,000, and budgeted variable costs of \$27 per direct labor hour.
- On July 1, 1988, machinery and equipment were purchased at a total invoice cost of \$325,000. Additional costs of \$23,000 to rectify damage on delivery and \$18,000 for concrete embedding of machinery were incurred. A wall had to be demolished to enable a large machine to be moved into the plant. The wall demolition cost \$7,000, and rebuilding of the wall cost \$19,000.
- On August 30, 1988, Nan purchased a new automobile for \$25,000.
- On September 30, 1988, a truck with a cost of \$48,000 and a carrying amount of \$30,000 on December 31, 1987 was sold for \$23,500.
- On November 4, 1988, Nan purchased a tract of land for investment purposes for \$700,000. Nan thinks it might use the land as a potential future building site.
- On December 20, 1988, a machine with a cost of \$17,000, a carrying amount of \$2,975 on date of disposition, and a market value of \$4,000 was given to a corporate officer in partial liquidation of a debt.

Required: Detach the tear-out worksheet on page 13.

a. Analyze the changes in each of the property, plant, and equipment accounts during 1988 by completing Schedule No. 1.

b.1. For each asset category, prepare a schedule showing calculations for depreciation or amortization expense for the year ended December 31, 1988. Round computations to the nearest whole dollar.

2. Analyze the changes in accumulated depreciation and amortization by completing Schedule No. 2.

c. Prepare a schedule showing gain or loss on disposition of property, plant, and equipment.

Accounting Practice — Part I

Number 4 (Tear-out Worksheet)
Uniform Certified Public Accountant Examination
November 1989

Candidate's No. _____
State _____
Question No. 4 **Page** _____

a.

Schedule 1

Nan Co.
**ANALYSIS OF CHANGES IN PROPERTY,
 PLANT, AND EQUIPMENT**
For the Year Ended December 31, 1988

	<i>Balance 12/31/87</i>	<i>Increase</i>	<i>Decrease</i>	<i>Balance 12/31/88</i>
Land	\$ 275,000			
Buildings	2,800,000			
Machinery and equipment	1,380,000			
Automobiles and trucks	210,000			
Leasehold improvements	432,000			
Totals	\$5,097,000			

b.2.

Schedule 2

Nan Co.
**ANALYSIS OF CHANGES IN ACCUMULATED
 DEPRECIATION AND AMORTIZATION**
For the Year Ended December 31, 1988

	<i>Balance 12/31/87</i>	<i>Increase</i>	<i>Decrease</i>	<i>Balance 12/31/88</i>
Buildings	\$ 672,900			
Machinery and equipment	367,500			
Automobiles and trucks	114,326			
Leasehold improvements	108,000			
Totals	\$1,262,726			

Examination Questions — November 1989

Number 5 (Estimated time — 40 to 50 minutes)

Presented below are the balance sheet accounts of Kern, Inc. as of December 31, 1988 and 1987 and their net changes.

	<u>1988</u>	<u>1987</u>	<u>Net change</u>
<i><u>Assets</u></i>			
Cash	\$ 471,000	\$ 307,000	\$ 164,000
Marketable equity securities, at cost	150,000	250,000	(100,000)
Allowance to reduce marketable equity securities to market	(10,000)	(25,000)	15,000
Accounts receivable, net	550,000	515,000	35,000
Inventories	810,000	890,000	(80,000)
Investment in Word Corp., at equity	420,000	390,000	30,000
Property, plant and equipment	1,145,000	1,070,000	75,000
Accumulated depreciation	(345,000)	(280,000)	(65,000)
Patent, net	109,000	118,000	(9,000)
Total assets	<u>\$3,300,000</u>	<u>\$3,235,000</u>	<u>\$ 65,000</u>
<i><u>Liabilities and Stockholders' Equity</u></i>			
Accounts payable and accrued liabilities	\$ 845,000	\$ 960,000	\$ (115,000)
Note payable, long-term	600,000	900,000	(300,000)
Deferred income taxes	190,000	190,000	—
Common stock, \$10 par value	850,000	650,000	200,000
Additional paid-in capital	230,000	170,000	60,000
Retained earnings	<u>585,000</u>	<u>365,000</u>	<u>220,000</u>
Total liabilities and stockholders' equity	<u>\$3,300,000</u>	<u>\$3,235,000</u>	<u>\$ 65,000</u>

Additional information:

- On January 2, 1988, Kern sold equipment costing \$45,000, with a carrying amount of \$28,000, for \$18,000 cash.
- On March 31, 1988, Kern sold one of its marketable equity security holdings for \$119,000 cash. There were no other transactions involving marketable equity securities.
- On April 15, 1988, Kern issued 20,000 shares of its common stock for cash at \$13 per share.
- On July 1, 1988, Kern purchased equipment for \$120,000 cash.
- Kern's net income for 1988 is \$305,000. Kern paid a cash dividend of \$85,000 on October 26, 1988.
- Kern acquired a 20% interest in Word Corp.'s common stock during 1985. There was no goodwill attributable to the investment which is appropriately accounted for by the equity method. Word reported net income of \$150,000 for the year ended December 31, 1988. No dividend was paid on Word's common stock during 1988.

Required:

Prepare a statement of cash flows for Kern, Inc. for the year ended December 31, 1988 using the indirect method. A worksheet is **not** required.

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WRITE YOUR 7-DIGIT CANDIDATE
NUMBER HERE. ONE DIGIT PER BOX.

EXAMINATION IN ACCOUNTING PRACTICE — PART II

November 2, 1989; 1:30 P.M. to 6:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	Point Value	Estimated Minutes	
		Minimum	Maximum
No. 1	10	45	55
No. 2	10	45	55
No. 3	10	45	55
No. 4	10	45	55
No. 5	10	40	50
Totals	50	220	270

INSTRUCTIONS TO CANDIDATES

FAILURE TO FOLLOW THESE INSTRUCTIONS MAY HAVE AN ADVERSE EFFECT ON YOUR EXAMINATION GRADE

- You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.
- Answer all objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since objective items are computer-graded, your comments and calculations associated with them are not considered. Be certain that you have entered your answers on the objective answer sheet before the examination time is up. **THE OBJECTIVE PORTION OF YOUR EXAMINATION WILL NOT BE GRADED IF YOU FAIL TO RECORD YOUR ANSWERS ON THE OBJECTIVE ANSWER SHEET.**
- Support all problem-type answers with properly labeled and legible calculations that can be identified as sources of amounts in formal schedules, entries, worksheets, or other answers, to show how your final answer was derived. Computation sheets should identify the question to which they relate, be placed immediately following the answer to that question, and be numbered in sequence with the other pages. Failure to enclose supporting calculations may result in loss of grading points because it may be impossible to determine how your amounts were computed.
- For Question Number 4 be sure to include the completed tear-out worksheet in the proper sequence with other answer sheets.
- A CPA is continually confronted with the necessity of expressing opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.
- WRITE YOUR 7-DIGIT CANDIDATE NUMBER IN THE SPACE PROVIDED AT THE UPPER RIGHT HAND CORNER OF THIS PAGE.**
- YOU MUST HAND IN YOUR EXAMINATION BOOKLET AND ANSWER PAPERS BEFORE LEAVING THE EXAMINATION ROOM. YOUR EXAMINATION WILL NOT BE GRADED UNLESS YOUR EXAMINATION BOOKLET AND ANSWER PAPERS ARE HANDED IN.**
- IF YOU WANT YOUR EXAMINATION BOOKLET MAILED TO YOU, WRITE YOUR NAME AND ADDRESS IN THE SPACE PROVIDED ON THE BACK COVER PAGE AND PLACE 45 CENTS POSTAGE IN THE SPACE PROVIDED, UNLESS OTHERWISE INSTRUCTED. EXAMINATION BOOKLETS WILL BE DISTRIBUTED NO SOONER THAN THE DAY FOLLOWING THE ADMINISTRATION OF THIS EXAMINATION.**

*Prepared by the Board of Examiners of the American Institute of Certified Public Accountants
and adopted by the examining boards of all states, the District of Columbia, Guam,
Puerto Rico, and the Virgin Islands of the United States.*

Instructions

Questions Number 1, 2, and 3 each consist of 20 multiple choice items. Select the **best** answer for each of the items. Use a soft pencil, preferably No. 2, to blacken the appropriate circle on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on the total number of correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

97. Gross billings for merchandise sold by Baker Co. to its customers last year amounted to \$5,260,000; sales returns and allowances reduced the amounts owed by \$160,000. Net sales were

- a. \$4,800,000
- b. \$5,100,000
- c. \$5,200,000
- d. \$5,260,000

Answer Sheet

97. (a) ☒ (c) ☐ (d) ☐

Number 1 (Estimated time — 45 to 55 minutes)

Select the **best** answer for each of the following items relating to a **variety of financial accounting problems**.

Items to be Answered

1. Ral Corp.'s checkbook balance on December 31, 1988 was \$5,000. In addition, Ral held the following items in its safe on that date:

Check payable to Ral Corp., dated January 2, 1989, in payment of a sale made in December 1988, not included in December 31 checkbook balance	\$2,000
Check payable to Ral Corp., deposited December 15 and included in December 31 checkbook balance, but returned by Bank on December 30 stamped "NSF." The check was redeposited on January 2, 1989 and cleared on January 9	500
Check drawn on Ral Corp.'s account, payable to a vendor, dated and recorded in Ral's books on December 31 but not mailed until January 10, 1989	300

The proper amount to be shown as Cash on Ral's balance sheet at December 31, 1988 is

- a. \$4,800
- b. \$5,300
- c. \$6,500
- d. \$6,800

2. Ross Corp. was organized on January 1, 1988. At December 31, 1988, Ross had the following investment portfolio of marketable equity securities:

	<u>In current assets</u>	<u>In noncurrent assets</u>
Aggregate cost	\$300,000	\$450,000
Aggregate market value	240,000	370,000
Net unrealized loss	<u>\$ 60,000</u>	<u>\$ 80,000</u>

All of the declines are judged to be temporary. Valuation allowances at December 31, 1988 should be established with corresponding charges against

	<u>Income</u>	<u>Stockholders' equity</u>
a.	\$0	\$140,000
b.	\$ 60,000	\$ 80,000
c.	\$ 80,000	\$ 60,000
d.	\$140,000	\$0

3. Lee Corp. reported the following long-term marketable equity security on its December 31, 1987 balance sheet:

Neu Corp. common stock, at cost	\$100,000
Less allowance for decline in market value	20,000
Balance	<u>\$ 80,000</u>

At December 31, 1988, the market value of Lee's investment in the Neu Corp. stock was \$85,000. As a result of the 1988 increase in this stock's market value, Lee's 1988 income statement should report

- a. An unrealized gain of \$5,000.
- b. A realized gain of \$5,000.
- c. An unrealized loss of \$15,000.
- d. No gain or loss.

4. Key Corp. issued 1,000 shares of its nonvoting preferred stock for all of Lev Corp.'s outstanding common stock. At the date of the transaction, Key's nonvoting preferred stock had a market value of \$100 per share, and Lev's tangible net assets had a book value of \$60,000. In addition, Key issued 100 shares of its nonvoting preferred stock to an individual as a finder's fee for arranging the transaction. As a result of this capital transaction, Key's total net assets would increase by

- a. \$0
- b. \$ 60,000
- c. \$100,000
- d. \$110,000

Accounting Practice — Part II

5. Lia Co.'s December 31, 1988 balance sheet reported the following current assets:

Cash	\$ 35,000
Accounts receivable	60,000
Inventories	30,000
Total	<u>\$125,000</u>

An analysis of the accounts disclosed that accounts receivable comprised the following:

Trade accounts	\$48,000
Allowance for uncollectible accounts	(1,000)
Selling price of Lia's unsold goods sent to Jax Co. on consignment at 130% of cost and not included in Lia's ending inventory	13,000
Total	<u>\$60,000</u>

At December 31, 1988, the correct total of Lia's current assets is

- \$112,000
- \$115,000
- \$122,000
- \$135,000

6. Par Corp. owns 60% of Sub Corp.'s outstanding capital stock. On May 1, 1988, Par advanced Sub \$70,000 in cash, which was still outstanding at December 31, 1988. What portion of this advance should be eliminated in the preparation of the December 31, 1988 consolidated balance sheet?

- \$70,000
- \$42,000
- \$28,000
- \$0

7. The following information pertains to Oro Corp.:

Credit sales for the year ended December 31, 1988	\$450,000
Credit balance in allowance for uncollectible accounts at January 1, 1988	10,800
Bad debts written off during 1988	18,000

According to past experience, 3% of Oro's credit sales have been uncollectible. After provision is made for bad debt expense for the year ended December 31, 1988, the allowance for uncollectible accounts balance would be

- \$ 6,300
- \$13,500
- \$24,300
- \$31,500

8. Kul Co., which began operations on January 1, 1988, appropriately uses the installment sales method of accounting. The following information is available for 1988:

Installment accounts receivable, December 31, 1988	\$400,000
Deferred gross profit, December 31, 1988 (before recognition of realized gross profit for 1988)	280,000
Gross profit on sales	40%

For the year ended December 31, 1988, cash collections and realized gross profit on installment sales should be

	<u>Cash collections</u>	<u>Realized gross profit</u>
a.	\$300,000	\$120,000
b.	\$300,000	\$160,000
c.	\$200,000	\$120,000
d.	\$200,000	\$160,000

9. Caba Co. recorded the following data pertaining to raw material Z during March 1989:

Date 1989	Units			On hand
	<u>Received</u>	<u>Cost</u>	<u>Issued</u>	
March 1 inventory		\$1.00		400
March 6 issue			200	200
March 30 purchase	600	\$1.20		800

The moving-weighted-average unit cost of Z inventory at March 31, 1989 is

- \$1.20
- \$1.15
- \$1.12
- \$1.10

10. The following information pertains to an inventory item:

Cost	\$12.00
Estimated selling price	13.60
Estimated disposal cost	.20
Normal gross margin	2.20
Replacement cost	10.90

Under the lower-of-cost-or-market rule, this inventory item should be valued at

- \$10.70
- \$10.90
- \$11.20
- \$12.00

Examination Questions — November 1989

11. Seco Corp. was incorporated on January 2, 1988. The following information pertains to Seco's common stock transactions:

<u>1988</u>		
January 2	Number of shares authorized	80,000
February 1	Number of shares issued	60,000
July 1	Number of shares reacquired but not canceled	5,000
December 1	Two-for-one stock split	

At December 31, 1988, the number of shares of Seco's common stock outstanding is

- a. 150,000
- b. 120,000
- c. 115,000
- d. 110,000

12. In 1980, Rona Corp. issued 5,000 shares of \$10 par value common stock for \$100 per share. In 1988, Rona reacquired 2,000 of its shares at \$150 per share from the estate of one of its deceased officers and immediately canceled these 2,000 shares. Rona uses the cost method in accounting for its treasury stock transactions. In connection with the retirement of these 2,000 shares, Rona should debit

	<u>Additional paid-in capital</u>	<u>Retained earnings</u>
a.	\$ 20,000	\$280,000
b.	\$100,000	\$180,000
c.	\$180,000	\$100,000
d.	\$280,000	\$0

13. On July 1, 1988, Alto Corp. split its common stock 5 for 1 when the market value was \$100 per share. Prior to the split, Alto had 10,000 shares of \$10 par value common stock issued and outstanding. After the split, the par value of the stock

- a. Remained at \$10.
- b. Was reduced to \$8.
- c. Was reduced to \$5.
- d. Was reduced to \$2.

14. At December 31, 1987 and 1988, Tri Corp. had outstanding 2,000 shares of \$100 par value 6% cumulative preferred stock and 10,000 shares of \$10 par value common stock. At December 31, 1987, dividends in arrears on the preferred stock were \$6,000. Cash dividends declared in 1988 totaled \$22,000. What amounts were payable on each class of stock?

	<u>Preferred stock</u>	<u>Common stock</u>
a.	\$12,000	\$10,000
b.	\$16,000	\$ 6,000
c.	\$18,000	\$ 4,000
d.	\$22,000	\$0

15. The first examination of Rudd Corp.'s financial statements was made for the year ended December 31, 1988. The auditor found that Rudd had purchased another company in January 1986 and had recorded goodwill of \$100,000 in connection with this purchase. It was determined that the goodwill had an estimated useful life of only five years because of obsolescence. No amortization of goodwill had ever been recorded. For the December 31, 1988 financial statements, Rudd should debit

	<u>Amortization expense</u>	<u>Retained earnings</u>
a.	\$0	\$100,000
b.	\$20,000	\$ 40,000
c.	\$33,333	\$0
d.	\$60,000	\$0

16. The following information pertains to Plat Corp.'s long-term marketable equity securities portfolio:

	<u>December 31,</u>	
	<u>1987</u>	<u>1988</u>
Cost	\$100,000	\$100,000
Market value	90,000	120,000

Differences between cost and market values are considered to be temporary. The decline in market value was properly accounted for at December 31, 1987. By what amount should the contra account — unrealized loss in long-term marketable equity securities — decrease from December 31, 1987 to December 31, 1988?

- a. \$0
- b. \$10,000
- c. \$20,000
- d. \$30,000

17. Gow and Cubb formed a partnership on March 1, 1989 and contributed the following assets:

	<u>Gow</u>	<u>Cubb</u>
Cash	\$80,000	
Equipment (market value)		\$50,000

The equipment was subject to a chattel mortgage of \$10,000 that was assumed by the partnership. The partners agreed to share profits and losses equally. Cubb's capital account at March 1, 1989 should be

- a. \$40,000
- b. \$45,000
- c. \$50,000
- d. \$60,000

Accounting Practice — Part II

18. The December 31, 1988 condensed balance sheet of Mason & Gross, a partnership, follows:

Current assets	\$125,000
Equipment (net)	15,000
Total assets	<u>\$140,000</u>
Liabilities	\$ 10,000
Mason, Capital	80,000
Gross, Capital	50,000
Total liabilities and capital	<u>\$140,000</u>

Market values at December 31, 1988 are as follows:

Current assets	\$90,000
Equipment	30,000
Liabilities	10,000

On January 2, 1989, the partnership was incorporated and 1,000 shares of \$5 par value common stock were issued. What amount should be credited to additional contributed capital?

- a. \$0
- b. \$105,000
- c. \$125,000
- d. \$135,000

19. Blau and Rubi are partners who share profits and losses in the ratio of 6:4, respectively. On May 1, 1989, their respective capital accounts were as follows:

Blau	\$60,000
Rubi	50,000

On that date, Lind was admitted as a partner with a one-third interest in capital and profits for an investment of \$40,000. The new partnership began with total capital of \$150,000. Immediately after Lind's admission, Blau's capital should be

- a. \$50,000
- b. \$54,000
- c. \$56,667
- d. \$60,000

20. Beck, the active partner in Beck & Cris, receives an annual bonus of 25% of partnership net income after deducting the bonus. For the year ended December 31, 1988, partnership net income before the bonus amounted to \$300,000. Beck's 1988 bonus should be

- a. \$56,250
- b. \$60,000
- c. \$62,500
- d. \$75,000

Number 2 (Estimated time — 45 to 55 minutes)

Select the **best** answer for each of the following items relating to a variety of managerial accounting problems.

Items to be Answered

21. The following information pertains to three shipping terminals operated by Krag Corp.:

<u>Terminal</u>	<u>Percentage of cargo handled</u>	<u>Percentage of error</u>
Land	50	2
Air	40	4
Sea	10	14

Krag's internal auditor randomly selects one set of shipping documents, ascertaining that the set selected contains an error. The probability that the error occurred in the Land Terminal is

- a. 2%
- b. 10%
- c. 25%
- d. 50%

22. Mili Co. plans to discontinue a division with a \$20,000 contribution to overhead. Overhead allocated to the division is \$50,000, of which \$5,000 cannot be eliminated. The effect of this discontinuance on Mili's pretax income would be an increase of

- a. \$ 5,000
- b. \$20,000
- c. \$25,000
- d. \$30,000

23. Diva Co. wants to establish a selling price that will yield a gross margin of 40% on sales of a product whose cost is \$12.00 per unit. The selling price should be

- a. \$16.80
- b. \$19.20
- c. \$20.00
- d. \$30.00

24. Palo Corp. manufactures one product with a standard direct labor cost of 2 hours at \$6.00 per hour. During March, 500 units were produced using 1,050 hours at \$6.10 per hour. The unfavorable direct labor efficiency variance is

- a. \$100
- b. \$105
- c. \$300
- d. \$305

Examination Questions — November 1989

25. The following information appeared in the accounting records of a retail store for the year ended December 31, 1988:

Sales	\$300,000
Purchases	140,000
Inventories	
January 1	70,000
December 31	100,000
Sales commissions	10,000

The gross margin was

- a. \$190,000
- b. \$180,000
- c. \$160,000
- d. \$150,000

26. Dahl Co. uses a standard costing system in connection with the manufacture of a "one size fits all" article of clothing. Each unit of finished product contains 2 yards of direct material. However, a 20% direct material spoilage calculated on input quantities occurs during the manufacturing process. The cost of the direct material is \$3 per yard. The standard direct material cost per unit of finished product is

- a. \$4.80
- b. \$6.00
- c. \$7.20
- d. \$7.50

27. The following information pertains to Sisk Co.:

Sales (25,000 units)	\$500,000
Direct materials and direct labor	150,000
Factory overhead:	
Variable	20,000
Fixed	35,000
Selling and general expenses:	
Variable	5,000
Fixed	30,000

Sisk's breakeven point in number of units is

- a. 4,924
- b. 5,000
- c. 6,250
- d. 9,286

28. The following information pertains to Mete Co.:

Sales	\$400,000
Variable costs	80,000
Fixed costs	20,000

Mete's breakeven point in sales dollars is

- a. \$ 20,000
- b. \$ 25,000
- c. \$ 80,000
- d. \$100,000

29. West Co.'s 1988 manufacturing costs were as follows:

Direct materials and direct labor	\$700,000
Other variable manufacturing costs	100,000
Depreciation of factory building and manufacturing equipment	80,000
Other fixed manufacturing overhead	18,000

What amount should be considered product cost for external reporting purposes?

- a. \$700,000
- b. \$800,000
- c. \$880,000
- d. \$898,000

30. During the month of April, Vane Co. produced and sold 10,000 units of a product. Manufacturing and selling costs incurred during April were as follows:

Direct materials and direct labor	\$400,000
Variable manufacturing overhead	90,000
Fixed manufacturing overhead	20,000
Variable selling costs	10,000

The product's unit cost under direct (variable) costing was

- a. \$49
- b. \$50
- c. \$51
- d. \$52

31. In preparing its cash budget for May 1989, Ben Co. made the following projections:

Sales	\$3,000,000
Gross margin (based on sales)	25%
Decrease in inventories	140,000
Decrease in accounts payable for inventories	240,000

For May 1989, the estimated cash disbursements for inventories were

- a. \$2,350,000
- b. \$2,110,000
- c. \$2,100,000
- d. \$1,870,000

32. In manufacturing its products for the month of March 1989, Elk Co. incurred normal spoilage of \$5,000 and abnormal spoilage of \$9,000. How much spoilage cost should Elk charge as a period cost for the month of March 1989?

- a. \$0
- b. \$ 5,000
- c. \$ 9,000
- d. \$14,000

Items 33 through 35 are based on the following information pertaining to Arp Co.'s manufacturing operations:

<u>Inventories</u>	<u>3/1/89</u>	<u>3/31/89</u>
Direct materials	\$36,000	\$30,000
Work-in-process	18,000	12,000
Finished goods	54,000	72,000

Additional information for the month of March 1989:

Direct materials purchased	\$84,000
Direct labor payroll	60,000
Direct labor rate per hour	7.50
Factory overhead rate per direct labor hour	10.00

33. For the month of March 1989, prime cost was
- \$ 90,000
 - \$120,000
 - \$144,000
 - \$150,000
34. For the month of March 1989, conversion cost was
- \$ 90,000
 - \$140,000
 - \$144,000
 - \$170,000
35. For the month of March 1989, cost of goods manufactured was
- \$218,000
 - \$224,000
 - \$230,000
 - \$236,000
36. Kern Co. is planning to invest in a two-year project that is expected to yield cash flows from operations, net of income taxes, of \$50,000 in the first year and \$80,000 in the second year. Kern requires an internal rate of return of 15%. The present value of \$1 for one period at 15% is 0.870 and for two periods at 15% is 0.756. The future value of \$1 for one period at 15% is 1.150 and for two periods at 15% is 1.323. The maximum that Kern should invest immediately is
- \$ 81,670
 - \$103,980
 - \$130,000
 - \$163,340

Items 37 and 38 are based on the following information pertaining to Yola Co.'s East Division for 1988:

Sales	\$620,000
Variable costs	500,000
Traceable fixed costs	100,000
Average invested capital	50,000
Imputed interest rate	18%

37. The return on investment was
- 40.00%
 - 29.00%
 - 18.00%
 - 8.33%
38. The residual income was
- \$ 3,600
 - \$ 9,000
 - \$11,000
 - \$20,000

39. Axe Co. has a job order cost system. The following debits (credits) appeared in the work-in-process account for the month of March 1989:

<u>March</u>	<u>Description</u>	<u>Amount</u>
1	Balance	\$ 2,000
31	Direct materials	12,000
31	Direct labor	8,000
31	Factory overhead	6,400
31	To finished goods	(24,000)

Axe applies overhead to production at a predetermined rate of 80% based on direct labor cost. Job No. 9, the only job still in process at the end of March 1989, has been charged with direct labor of \$1,000. The amount of direct materials charged to Job No. 9 was

- \$12,000
 - \$ 4,400
 - \$ 2,600
 - \$ 1,500
40. Doro Co. is considering the purchase of a \$100,000 machine that is expected to result in a decrease of \$25,000 per year in cash expenses after taxes. This machine, which has no residual value, has an estimated useful life of 10 years and will be depreciated on a straight-line basis. For this machine, the accounting rate of return based on initial investment would be
- 10%
 - 15%
 - 25%
 - 35%

Number 3 (Estimated time — 45 to 55 minutes)

Select the best answer for each of the following items relating to the federal taxation of corporations, partnerships, and exempt organizations. The answers should be based on the Internal Revenue Code and Tax Regulations in effect for the tax period specified in the item. If no tax period is specified, use the *current* Internal Revenue Code and Tax Regulations.

Items to be Answered

Items 41 through 46 are based on the following:

Kell Corp.
INCOME STATEMENT
For the Year Ended December 31, 1988

Sales		\$900,000
Cost of sales		<u>600,000</u>
Gross margin		300,000
Operating expenses		<u>250,000</u>
Operating income		50,000
Other income:		
Gain on sale of investments	\$15,000	
Life insurance policy proceeds	10,000	
Dividends	<u>3,000</u>	<u>28,000</u>
Total		78,000
Other expense:		
Contributions		<u>8,000</u>
Income before income tax		<u><u>\$ 70,000</u></u>

41. The gain on sale of investments resulted from the sale of stock of an unrelated taxable domestic corporation. This stock had been purchased in 1980. In its 1988 income tax return, Kell should claim a long-term capital gain deduction of

- a. \$0
- b. \$ 6,000
- c. \$ 9,000
- d. \$12,000

42. The life insurance policy proceeds represent a lump-sum payment in full as a result of the death of Kell's controller. Kell was the owner and beneficiary of this policy. In its 1988 income tax return, Kell should report taxable life insurance proceeds of

- a. \$10,000
- b. \$ 8,000
- c. \$ 5,000
- d. \$0

43. The dividends were declared and received in 1988 from an unrelated taxable domestic corporation in which Kell owned less than 1 % of the investee's stock. Kell had no portfolio indebtedness. In its 1988 income tax return, Kell should claim a dividends-received deduction of

- a. \$0
- b. \$ 100
- c. \$2,100
- d. \$2,400

44. All of the contributions were to qualified charitable organizations. When Kell computes the maximum allowable deduction for contributions, what percentage of contribution base income should Kell use?

- a. 50%
- b. 30%
- c. 10%
- d. 5%

45. Included in Kell's operating expenses were the following life insurance premiums:

Term life insurance premiums paid on the life of Kell's controller, with Kell as owner and beneficiary of the policy	\$ 2,000
Group-term life insurance premiums paid on employees' lives, with the employees' dependents as owners and beneficiaries of the policies	18,000

In its 1988 income tax return, what amount should Kell deduct for life insurance premiums?

- a. \$20,000
- b. \$18,000
- c. \$ 2,000
- d. \$0

46. Included in Kell's operating expenses is \$4,000 for depreciation of a machine that Kell purchased and placed in service in January 1988 for use in the active conduct of Kell's business. This machine cost \$32,000 and has an estimated useful life of eight years, with no salvage value. No other fixed assets were acquired during 1988. Kell has taxable income and wishes to minimize its 1988 income tax to the fullest possible extent. The proper election was made in connection with the tax treatment of this machine in Kell's 1988 income tax return. Excluding normal depreciation, Kell may expense on this machine a maximum of

- a. \$0
- b. \$ 5,000
- c. \$10,000
- d. \$32,000

Accounting Practice — Part II

47. In the computation of a corporation's taxable income for a particular year, a net capital loss sustained in that year is
- Limited to a maximum deduction of \$3,000.
 - Deductible in full.
 - Deductible to a maximum extent of 50%.
 - Not deductible.
48. With regard to consolidated returns, which one of the following statements is correct?
- The common parent must directly own 51 % or more of the total voting power of all corporations included in the consolidated return.
 - Of all intercompany dividends paid by the subsidiaries to the parent, 70% are excludible from taxable income on the consolidated return.
 - Only corporations that issue their audited financial statements on a consolidated basis may file consolidated tax returns.
 - Operating losses of one group member may be used to offset operating profits of the other members included in the consolidated return.
49. Ati Corp. has two common stockholders. Ati derives all of its income from investments in stocks and securities, and it regularly distributes 51 % of its taxable income as dividends to its stockholders. Ati is a
- Personal holding company.
 - Regulated investment company.
 - Corporation subject to the accumulated earnings tax.
 - Corporation subject to tax only on income not distributed to stockholders.
50. With regard to S corporations and their stockholders, the "at risk" rules applicable to losses
- Depend on the type of income reported by the S corporation.
 - Are subject to the elections made by the S corporation's stockholders.
 - Take into consideration the S corporation's ratio of debt to equity.
 - Apply at the shareholder level rather than at the corporate level.
51. An S corporation may deduct
- Charitable contributions within the percentage of income limitation applicable to corporations.
 - Net operating loss carryovers.
 - Foreign income taxes.
 - Compensation of officers.
52. How does a noncorporate shareholder treat the gain on a redemption of stock that qualifies as a partial liquidation of the distributing corporation?
- Entirely as capital gain.
 - Entirely as a dividend.
 - Partly as capital gain and partly as a dividend.
 - As a tax-free transaction.
53. Rela Associates, a partnership, transferred all of its assets, with a basis of \$300,000, subject to liabilities of \$50,000, to a newly formed corporation in return for all of the corporation's stock. Rela then distributed this stock to the partners in liquidation. In connection with this incorporation of the partnership, Rela recognizes
- No gain or loss on the transfer of its assets nor on the assumption of Rela's liabilities by the corporation.
 - Gain on the assumption of Rela's liabilities by the corporation.
 - Gain or loss on the transfer of its assets to the corporation.
 - Gain, but not loss, on the transfer of its assets to the corporation.
54. On June 1, 1988, Don Kerr received a 10% interest in the capital of Rev Company, a partnership, for services rendered. Rev's net assets at June 1 had a basis of \$35,000 and a fair market value of \$50,000. What income must Kerr include in his 1988 tax return for the partnership interest transferred to him by the other partners?
- \$5,000 capital gain.
 - \$5,000 ordinary income.
 - \$3,500 capital gain.
 - \$3,500 ordinary income.
55. The following information pertains to Carr's admission to the Smith & Jones partnership on July 1, 1988:
- Carr's contribution of capital: 800 shares of Ed Corp. stock bought in 1975 for \$30,000; fair market value \$150,000 on July 1, 1988.
- Carr's interest in capital and profits of Smith & Jones: 25%.
- Fair market value of net assets of Smith & Jones on July 1, 1988 after Carr's admission: \$600,000.
- Carr's gain in 1988 on the exchange of the Ed stock for Carr's partnership interest was
- \$120,000 ordinary income.
 - \$120,000 long-term capital gain.
 - \$120,000 Section 1231 gain.
 - \$0.

Examination Questions — November 1989

56. Doris and Lydia are equal partners in the capital and profits of Agee & Nolan, but are otherwise unrelated. The following information pertains to 300 shares of Mast Corp. stock sold by Lydia to Agee & Nolan:

Year of purchase	1980
Year of sale	1988
Basis (cost)	\$9,000
Sales price (equal to fair market value)	\$4,000

The amount of long-term capital loss that Lydia realized in 1988 on the sale of this stock was

- a. \$5,000
- b. \$3,000
- c. \$2,500
- d. \$0

57. The basis of property (other than money) distributed by a partnership to a partner, in complete liquidation of the partner's interest, shall be an amount equal to the

- a. Fair market value of the property.
- b. Book value of the property.
- c. Adjusted basis of such partner's interest in the partnership, reduced by any money distributed in the same transaction.
- d. Adjusted basis of such partner's interest in the partnership, increased by any money distributed in the same transaction.

58. Which one of the following types of organizations qualifies as an organization exempt from income tax?

- a. An "action" organization established for the purpose of influencing legislation pertaining to protection of animal rights.
- b. All "feeder" organizations, primarily conducting businesses for profit, but distributing 100% of their profits to organizations exempt from income tax.
- c. A social club organized and operated exclusively for the pleasure and recreation of its members, supported solely by membership fees, dues, and assessments.
- d. An organization whose purpose is to foster national or international amateur sports competition by providing athletic facilities and equipment.

59. To qualify as an exempt organization other than an employees' qualified pension or profit-sharing trust, the applicant

- a. Is barred from incorporating and issuing capital stock.
- b. Must file a written application with the Internal Revenue Service.
- c. Cannot operate under the "lodge system" under which payments are made to its members for sick benefits.
- d. Need **not** be specifically identified as one of the classes on which exemption is conferred by the Internal Revenue Code, provided that the organization's purposes and activities are of a nonprofit nature.

60. With regard to unrelated business income of an exempt organization, which one of the following statements is correct?

- a. An unrelated trade or business activity that results in a loss is excluded from the definition of unrelated business.
- b. The tax on unrelated business income can be imposed even if the unrelated business activity is intermittent and is carried on once a year.
- c. An exempt organization is **not** taxed on unrelated business income of less than \$1,000.
- d. An exempt organization that earns any unrelated business income in excess of \$100,000 during a particular year will lose its exempt status for that particular year.

Accounting Practice — Part II

Number 4 (Estimated time — 45 to 55 minutes)

Children's Agency, a voluntary health and welfare organization, conducts two programs: Medical Services Program and Community Information Services Program. It had the following transactions during the year ended June 30, 1989:

1. Received the following contributions:

Unrestricted pledges	\$800,000
Restricted cash	95,000
Building fund pledges	50,000
Endowment fund cash	1,000
2. Collected the following pledges:

Unrestricted	450,000
Building fund	20,000
3. Received the following unrestricted cash revenues:

From theatre party (net of direct costs)	12,000
Bequests	10,000
Membership dues	8,000
Interest and dividends	5,000
4. Program expenses incurred (processed through vouchers payable):

Medical services	60,000
Community information services	15,000
5. Services expenses incurred (processed through vouchers payable):

General administration	150,000
Fund raising	200,000
6. Fixed assets purchased with unrestricted cash 18,000
7. Depreciation of all buildings and equipment in the land, buildings, and equipment fund was allocated as follows:

Medical services program	4,000
Community information services program	3,000
General administration	6,000
Fund raising	2,000
8. Paid vouchers payable 330,000

Required: Detach the tear-out worksheet on page 26.

On the tear-out worksheet on page 26, record the journal entries (without explanations) for the preceding transactions. With credit amounts placed in parentheses, insert the amounts in the proper columns for each of the following funds:

Current Fund — Unrestricted
Current Fund — Restricted
Land, Buildings, and Equipment Fund
Endowment Fund

Number the journal entries to coincide with the transaction numbers indicated.

Examination Questions — November 1989

Number 4 (Tear-out Worksheet)
Accounting Practice — Part II
November 1989

Candidate's No. _____
State _____
Question No. 4 **Page** _____

Children's Agency
JOURNAL ENTRIES
For the Year Ended June 30, 1989

[illegible]

Accounting Practice — Part II

Number 5 (Estimated time — 40 to 50 minutes)

The following information pertains to Fred and Laura Shaw, a married couple filing a joint federal income tax return for the calendar year 1988:

Fred, age 73 — cash received in 1988

Salary — employed as an industrial engineer			
Gross amount		\$80,000	
Amounts withheld			
Federal income tax	\$17,000		
State income tax	4,000		
FICA taxes	3,380		
Medical insurance premiums	1,200	25,580	
Net amount received			\$54,420
Social security benefits			12,000
Dividends on life insurance policy (accumulated net premiums not exceeded)			400

Laura, age 61 — cash received in 1988

Salary — from part-time employment			
Gross amount		\$15,000	
Amounts withheld			
Federal income tax	\$ 2,800		
State income tax	120		
FICA taxes	1,127	4,047	
Net amount received			10,953
Unemployment compensation benefits			600

Cash received jointly in 1988

Proceeds from sale of stock (Bought in 1970 — basis \$9,000)	2,500
Dividends from taxable domestic corporations	527
Interest on U.S. Government Savings Bonds	100
Total cash received	<u>\$81,500</u>

Cash disbursed in 1988

Household and miscellaneous personal expenses	\$50,000
State sales taxes substantiated by receipts	1,900
Estimated 1988 federal income tax payments	2,000
Fee paid to CPA for tax return preparation	250
Unreimbursed business travel away from home overnight	900
Continuing professional education courses required to maintain job skills	700
Membership dues to Society of Industrial Engineers	150
Contribution to a national political party	200
Realty taxes on primary residence	3,000
Realty taxes on summer cottage	800
Mortgage interest on primary residence	2,300
Mortgage principal on primary residence	500
Mortgage interest on summer cottage (no payments on principal)	1,800
Total cash disbursed	<u>\$64,500</u>

Number 5 (continued)

Additional information:

- The 1987 joint federal income tax return showed a tax overpayment of \$43, which the Shaws elected to credit to their 1988 estimated tax.
- The 1987 joint state income tax return showed no balance of tax due or overpayment.
- In June 1988, Fred donated 500 shares of stock of a listed corporation to a recognized charitable organization. Fred's basis for this stock, which was bought in 1975, was \$1,100. Fair market value of this stock on the date of the donation was \$1,400.
- In July 1988, the summer cottage, which was not insured, sustained fire damage. Information pertaining to this property is as follows:

Basis	\$40,000
Fair market value immediately before the fire	66,000
Fair market value immediately after the fire	50,000

- The Shaws supported their daughter, Doris, who had been disabled since infancy, and who lived in the Shaw household. Doris had no income. She died on January 2, 1988.
- Personal exemptions and dependency exemptions are \$1,950 each for 1988.
- The basic standard deduction is \$5,000 and the additional standard deduction is \$600 for 1988.

Required:

- Prepare a detailed schedule computing Fred and Laura Shaw's joint taxable income for 1988. Show each appropriate item separately in the schedule, and classify each item properly. Any possible alternative treatment should be resolved in a manner that will minimize 1988 taxable income. Round to the nearest dollar.
- Assume that Fred and Laura Shaw's 1988 federal income tax on their 1988 joint taxable income is \$16,946 before tax credits and payments. Compute the net amount of tax payable or net overpayment of tax.

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WRITE YOUR 7-DIGIT CANDIDATE
NUMBER HERE. ONE DIGIT PER BOX.

EXAMINATION IN AUDITING

November 2, 1989; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	Point Value	Estimated Minutes	
		Minimum	Maximum
No. 1	60	90	110
No. 2	10	15	25
No. 3	10	15	25
No. 4	10	15	25
No. 5	10	15	25
Totals	<u>100</u>	<u>150</u>	<u>210</u>

INSTRUCTIONS TO CANDIDATES

FAILURE TO FOLLOW THESE INSTRUCTIONS MAY HAVE AN ADVERSE EFFECT ON YOUR EXAMINATION GRADE

- You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.
- Answer **all** objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since objective items are computer-graded, your comments and calculations associated with them are not considered. Be certain that you have entered your answers on the objective answer sheet before the examination time is up. **THE OBJECTIVE PORTION OF YOUR EXAMINATION WILL NOT BE GRADED IF YOU FAIL TO RECORD YOUR ANSWERS ON THE OBJECTIVE ANSWER SHEET.**
- A CPA is continually confronted with the necessity of expressing opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.
- WRITE YOUR 7-DIGIT CANDIDATE NUMBER IN THE SPACE PROVIDED AT THE UPPER RIGHT HAND CORNER OF THIS PAGE.**
- YOU MUST HAND IN YOUR EXAMINATION BOOKLET AND ANSWER PAPERS BEFORE LEAVING THE EXAMINATION ROOM. YOUR EXAMINATION WILL NOT BE GRADED UNLESS YOUR EXAMINATION BOOKLET AND ANSWER PAPERS ARE HANDED IN.**
- IF YOU WANT YOUR EXAMINATION BOOKLET MAILED TO YOU, WRITE YOUR NAME AND ADDRESS IN THE SPACE PROVIDED ON THE BACK COVER PAGE AND PLACE 45 CENTS POSTAGE IN THE SPACE PROVIDED, UNLESS OTHERWISE INSTRUCTED. EXAMINATION BOOKLETS WILL BE DISTRIBUTED NO SOONER THAN THE DAY FOLLOWING THE ADMINISTRATION OF THIS EXAMINATION.**

*Prepared by the Board of Examiners of the American Institute of Certified Public Accountants
and adopted by the examining boards of all states, the District of Columbia, Guam,
Puerto Rico, and the Virgin Islands of the United States.*

Number 1 (Estimated time — 90 to 110 minutes)

Instructions

Select the **best** answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate circle on the separate printed answer sheet to indicate your answer. **Mark only one answer for each item. Answer all items.** Your grade will be based on the total number of correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

96. One of the generally accepted auditing standards specifies that the auditor should
- Inspect all property and equipment acquired during the year.
 - Charge fair fees based on cost.
 - Exercise due professional care in the performance of the audit.
 - Count client petty cash funds.

Answer Sheet

96. (a) (b) ☒ (c) (d)

Items to be Answered

- When a principal auditor decides to make reference to another auditor's examination, the principal auditor's report should always indicate clearly, in the introductory, scope, and opinion paragraphs, the
 - Magnitude of the portion of the financial statements examined by the other auditor.
 - Disclaimer of responsibility concerning the portion of the financial statements examined by the other auditor.
 - Name of the other auditor.
 - Division of responsibility.
- When there is a significant change in accounting principle, an auditor's report should refer to the lack of consistency in
 - The scope paragraph.
 - An explanatory paragraph between the second paragraph and the opinion paragraph.
 - The opinion paragraph.
 - An explanatory paragraph following the opinion paragraph.

- How are management's responsibility and the auditor's responsibility represented in the standard auditor's report?

	<u>Management's responsibility</u>	<u>Auditor's responsibility</u>
a.	Explicitly	Explicitly
b.	Implicitly	Implicitly
c.	Implicitly	Explicitly
d.	Explicitly	Implicitly

- Restrictions imposed by a client prohibit the observation of physical inventories, which account for 35% of all assets. Alternative audit procedures cannot be applied, although the auditor was able to examine satisfactory evidence for all other items in the financial statements. The auditor should issue a(an)
 - "Except for" qualified opinion.
 - Disclaimer of opinion.
 - Unqualified opinion with a separate explanatory paragraph.
 - Unqualified opinion with an explanation in the scope paragraph.
- When an accountant performs more than one level of service (for example, a compilation and a review, or a compilation and an audit) concerning the financial statements of a nonpublic entity, the accountant generally should issue the report that is appropriate for
 - The lowest level of service rendered.
 - The highest level of service rendered.
 - A compilation engagement.
 - A review engagement.
- An accountant who reviews the financial statements of a nonpublic entity should issue a report stating that a review
 - Is substantially less in scope than an audit.
 - Provides negative assurance that the internal control structure is functioning as designed.
 - Provides only limited assurance that the financial statements are fairly presented.
 - Is substantially more in scope than a compilation.
- A limitation on the scope of an auditor's examination sufficient to preclude an unqualified opinion will usually result when management
 - Presents financial statements that are prepared in accordance with the cash receipts and disbursements basis of accounting.
 - States that the financial statements are **not** intended to be presented in conformity with generally accepted accounting principles.
 - Does **not** make the minutes of the Board of Directors' meetings available to the auditor.
 - Asks the auditor to report on the balance sheet and **not** on the other basic financial statements.

Auditing

8. Grant Company's financial statements adequately disclose uncertainties that concern future events, the outcome of which are **not** susceptible of reasonable estimation. The auditor's report should include a(an)

- a. Unqualified opinion.
- b. "Subject to" qualified opinion.
- c. "Except for" qualified opinion.
- d. Adverse opinion.

9. An auditor concludes that there is substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time. If the entity's disclosures concerning this matter are adequate, the audit report may include a(an)

	<u>Disclaimer of opinion</u>	<u>"Except for" qualified opinion</u>
a.	Yes	Yes
b.	No	No
c.	No	Yes
d.	Yes	No

10. An auditor may issue a qualified opinion under which of the following circumstances?

	<u>Lack of sufficient competent evidential matter</u>	<u>Restrictions on the scope of the audit</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

11. When reporting on comparative financial statements, an auditor ordinarily should change the previously issued opinion on the prior year's financial statements if

- a. The prior year's opinion was unqualified and the opinion on the current year's financial statements is modified due to a lack of consistency.
- b. The prior year's financial statements are restated following a pooling of interests in the current year.
- c. The prior year's financial statements are restated to conform with generally accepted accounting principles.
- d. The auditor is a predecessor auditor who has been requested by a former client to reissue the previously issued report.

12. Does an auditor make the following representations explicitly or implicitly when issuing the standard auditor's report on comparative financial statements?

	<u>Consistent application of accounting principles</u>	<u>Examination of evidence on a test basis</u>
a.	Explicitly	Explicitly
b.	Implicitly	Implicitly
c.	Implicitly	Explicitly
d.	Explicitly	Implicitly

13. An auditor should disclose the substantive reasons for expressing an adverse opinion in an explanatory paragraph

- a. Preceding the scope paragraph.
- b. Preceding the opinion paragraph.
- c. Following the opinion paragraph.
- d. Within the notes to the financial statements.

14. When management does **not** provide reasonable justification that a change in accounting principle is preferable and it presents comparative financial statements, the auditor should express a qualified opinion

- a. Only in the year of the accounting principle change.
- b. Each year that the financial statements initially reflecting the change are presented.
- c. Each year until management changes back to the accounting principle formerly used.
- d. Only if the change is to an accounting principle that is **not** generally accepted.

15. When an accountant compiles a nonpublic entity's financial statements that omit substantially all disclosures required by generally accepted accounting principles, the accountant should indicate in the compilation report that the financial statements are

- a. Restricted for internal use only by the entity's management.
- b. Not to be given to financial institutions for the purpose of obtaining credit.
- c. Compiled in conformity with a comprehensive basis of accounting other than generally accepted accounting principles.
- d. Not designed for those who are uninformed about the omitted disclosures.

16. When an independent CPA is associated with the financial statements of a publicly held entity but has **not** audited or reviewed such statements, the appropriate form of report to be issued must include a(an)

- a. Compilation report.
- b. Disclaimer of opinion.
- c. Unaudited association report.
- d. Qualified opinion.

Examination Questions — November 1989

17. The objective of a review of interim financial information is to provide an accountant with a basis for reporting whether
- The financial statements are presented fairly in accordance with generally accepted accounting principles.
 - A reasonable basis exists for expressing an updated opinion regarding the financial statements that were previously audited.
 - Material modifications should be made to conform with generally accepted accounting principles.
 - The financial statements are presented fairly in accordance with standards of interim reporting.
18. When an auditor is requested to express an opinion on the rental and royalty income of an entity, the auditor may
- Not accept the engagement because to do so would be tantamount to agreeing to issue a piecemeal opinion.
 - Not accept the engagement unless also engaged to audit the full financial statements of the entity.
 - Accept the engagement provided the auditor's opinion is expressed in a special report.
 - Accept the engagement provided distribution of the auditor's report is limited to the entity's management.
19. Negative assurance may be expressed when an accountant is requested to report on the
- Compilation of prospective financial statements.
 - Compliance with the provisions of the Foreign Corrupt Practices Act.
 - Results of applying agreed-upon procedures to an account within unaudited financial statements.
 - Audit of historical financial statements.
20. When an accountant compiles projected financial statements, the accountant's report should include a separate paragraph that
- Describes the differences between a projection and a forecast.
 - Identifies the accounting principles used by management.
 - Expresses limited assurance that the actual results may be within the projection's range.
 - Describes the limitations on the projection's usefulness.
21. When an accountant examines a financial forecast that fails to disclose several significant assumptions used to prepare the forecast, the accountant should describe the assumptions in the accountant's report and issue a(an)
- "Except for" qualified opinion.
 - "Subject to" qualified opinion.
 - Unqualified opinion with a separate explanatory paragraph.
 - Adverse opinion.
22. Soon after Boyd's audit report was issued, Boyd learned of certain related party transactions that occurred during the year under audit. These transactions were not disclosed in the notes to the financial statements. Boyd should
- Plan to audit the transactions during the next engagement.
 - Recall all copies of the audited financial statements.
 - Determine whether the lack of disclosure would affect the auditor's report.
 - Ask the client to disclose the transactions in subsequent interim statements.
23. A former client requests a predecessor auditor to reissue an audit report on a prior period's financial statements. The financial statements are not restated and the report is not revised. What date(s) should the predecessor auditor use in the reissued report?
- The date of the prior-period report.
 - The date of the client's request.
 - The date of reissue.
 - The dual-dates.
24. Management of Hill Company has decided not to account for a material transaction in accordance with the provisions of an FASB Standard. In setting forth its reasons in a note to the financial statements, management has clearly demonstrated that due to unusual circumstances the financial statements presented in accordance with the FASB Standard would be misleading. The auditor's report should include a separate explanatory paragraph and contain a(an)
- "Except for" qualified opinion.
 - "Subject to" qualified opinion.
 - Adverse opinion.
 - Unqualified opinion.

Auditing

25. If information accompanying the basic financial statements in an auditor-submitted document has been subjected to auditing procedures, the auditor may express an opinion that the accompanying information is fairly stated in
- Conformity with generally accepted accounting principles.
 - All material respects in relation to the basic financial statements taken as a whole.
 - Conformity with standards established by the AICPA.
 - Accordance with generally accepted auditing standards.
26. When using the work of a specialist, an auditor may refer to and identify the specialist in the auditor's report if the
- Auditor wishes to indicate a division of responsibility.
 - Specialist's work provides the auditor greater assurance of reliability.
 - Auditor expresses an adverse opinion as a result of the specialist's findings.
 - Specialist is not independent of the client.
27. Negative confirmation of accounts receivable is less effective than positive confirmation of accounts receivable because
- A majority of recipients usually lack the willingness to respond objectively.
 - Some recipients may report incorrect balances that require extensive follow-up.
 - The auditor can not infer that all nonrespondents have verified their account information.
 - Negative confirmations do not produce evidential matter that is statistically quantifiable.
28. An auditor's program to examine long-term debt should include steps that require
- Examining bond trust indentures.
 - Inspecting the accounts payable subsidiary ledger.
 - Investigating credits to the bond interest income account.
 - Verifying the existence of the bondholders.
29. Which of the following audit procedures would most likely assist an auditor in identifying conditions and events that may indicate there could be substantial doubt about an entity's ability to continue as a going concern?
- Review compliance with the terms of debt agreements.
 - Confirmation of accounts receivable from principal customers.
 - Reconciliation of interest expense with debt outstanding.
 - Confirmation of bank balances.
30. Which of the following documentation is required for an audit in accordance with generally accepted auditing standards?
- An internal control questionnaire.
 - A client engagement letter.
 - A planning memorandum or checklist.
 - A client representation letter.
31. When an accounting application is processed by computer, an auditor can not verify the reliable operation of programmed control procedures by
- Manually comparing detail transaction files used by an edit program to the program's generated error listings to determine that errors were properly identified by the edit program.
 - Constructing a processing system for accounting applications and processing actual data from throughout the period through both the client's program and the auditor's program.
 - Manually reperforming, as of a point in time, the processing of input data and comparing the simulated results to the actual results.
 - Periodically submitting auditor-prepared test data to the same computer process and evaluating the results.
32. To obtain evidence that user identification and password controls are functioning as designed, an auditor would most likely
- Attempt to sign-on to the system using invalid user identifications and passwords.
 - Write a computer program that simulates the logic of the client's access control software.
 - Extract a random sample of processed transactions and ensure that the transactions were appropriately authorized.
 - Examine statements signed by employees stating that they have not divulged their user identifications and passwords to any other person.
33. While performing a substantive test of details during an audit, the auditor determined that the sample results supported the conclusion that the recorded account balance was materially misstated. It was, in fact, not materially misstated. This situation illustrates the risk of
- Incorrect rejection.
 - Incorrect acceptance.
 - Overreliance.
 - Underreliance.
34. Which of the following would be designed to estimate a numerical measurement of a population, such as a dollar value?
- Sampling for variables.
 - Sampling for attributes.
 - Discovery sampling.
 - Numerical sampling.

35. Before performing a review of a nonpublic entity's financial statements, an accountant should
- Complete a series of inquiries concerning the entity's procedures for recording, classifying, and summarizing transactions.
 - Apply analytical procedures to provide limited assurance that **no** material modifications should be made to the financial statements.
 - Obtain a sufficient level of knowledge of the accounting principles and practices of the industry in which the entity operates.
 - Inquire whether management has omitted substantially all of the disclosures required by generally accepted accounting principles.
36. An auditor uses the knowledge provided by the understanding of the internal control structure and the assessed level of control risk primarily to
- Determine whether procedures and records concerning the safeguarding of assets are reliable.
 - Ascertain whether the opportunities to allow any person to both perpetrate and conceal irregularities are minimized.
 - Modify the initial assessments of inherent risk and preliminary judgments about materiality levels.
 - Determine the nature, timing, and extent of substantive tests for financial statement assertions.
37. An auditor's flowchart of a client's accounting system is a diagrammatic representation that depicts the auditor's
- Program for tests of controls.
 - Understanding of the system.
 - Understanding of the types of irregularities that are probable, given the present system.
 - Documentation of the study and evaluation of the system.
38. Computer systems are typically supported by a variety of utility software packages that are important to an auditor because they
- May enable unauthorized changes to data files if **not** properly controlled.
 - Are very versatile programs that can be used on hardware of many manufacturers.
 - May be significant components of a client's application programs.
 - Are written specifically to enable auditors to extract and sort data.
39. When obtaining an understanding of an entity's control environment, an auditor should concentrate on the substance of management's policies and procedures rather than their form because
- The auditor may believe that the policies and procedures are inappropriate for that particular entity.
 - The board of directors may **not** be aware of management's attitude toward the control environment.
 - Management may establish appropriate policies and procedures but **not** act on them.
 - The policies and procedures may be so weak that **no** reliance is contemplated by the auditor.
40. After obtaining an understanding of an entity's internal control structure and assessing control risk, an auditor may next
- Perform tests of controls to verify management's assertions that are embodied in the financial statements.
 - Consider whether evidential matter is available to support a further reduction in the assessed level of control risk.
 - Apply analytical procedures as substantive tests to validate the assessed level of control risk.
 - Evaluate whether the internal control structure policies and procedures detected material misstatements in the financial statements.
41. An auditor is **least** likely to test the internal controls that provide for
- Approval of the purchase and sale of marketable securities.
 - Classification of revenue and expense transactions by product line.
 - Segregation of the functions of recording disbursements and reconciling the bank account.
 - Comparison of receiving reports and vendors' invoices with purchase orders.
42. The possibility of erasing a large amount of information stored on magnetic tape most likely would be reduced by the use of
- File protection rings.
 - Check digits.
 - Completeness tests.
 - Conversion verification.

43. Which of the following most likely represents a weakness in the internal control structure of an EDP system?
- The systems analyst reviews output and controls the distribution of output from the EDP department.
 - The accounts payable clerk prepares data for computer processing and enters the data into the computer.
 - The systems programmer designs the operating and control functions of programs and participates in testing operating systems.
 - The control clerk establishes control over data received by the EDP department and reconciles control totals after processing.
44. Evidential matter concerning proper segregation of duties ordinarily is best obtained by
- Inspection of third-party documents containing the initials of who applied control procedures.
 - Direct personal observation of the employee who applies control procedures.
 - Preparation of a flowchart of duties performed and available personnel.
 - Making inquiries of co-workers about the employee who applies control procedures.
45. An internal control narrative indicates that an approved voucher is required to support every check request for payment of merchandise. Which of the following procedures provides the greatest assurance that this control is operating effectively?
- Select and examine vouchers and ascertain that the related cancelled checks are dated **no** later than the vouchers.
 - Select and examine vouchers and ascertain that the related cancelled checks are dated **no** earlier than the vouchers.
 - Select and examine cancelled checks and ascertain that the related vouchers are dated **no** earlier than the checks.
 - Select and examine cancelled checks and ascertain that the related vouchers are dated **no** later than the checks.
46. For effective internal control purposes, the vouchers payable department generally should
- Stamp, perforate, or otherwise cancel supporting documentation after payment is mailed.
 - Ascertain that each requisition is approved as to price, quantity, and quality by an authorized employee.
 - Obliterate the quantity ordered on the receiving department copy of the purchase order.
 - Establish the agreement of the vendor's invoice with the receiving report and purchase order.
47. An auditor's tests of controls over the issuance of raw materials to production would most likely include
- Reconciling raw materials and work in process perpetual inventory records to general ledger balances.
 - Inquiring of the custodian about the procedures followed when defective materials are received from vendors.
 - Observing that raw materials are stored in secure areas and that storeroom security is supervised by a responsible individual.
 - Examining material requisitions and reperforming client controls designed to process and record issuances.
48. A weakness in internal control over recording retirements of equipment may cause an auditor to
- Trace additions to the "other assets" account to search for equipment that is still on hand but **no** longer being used.
 - Select certain items of equipment from the accounting records and locate them in the plant.
 - Inspect certain items of equipment in the plant and trace those items to the accounting records.
 - Review the subsidiary ledger to ascertain whether depreciation was taken on each item of equipment during the year.
49. The third general standard states that due care is to be exercised in the performance of an audit. This standard is generally interpreted to require
- Objective review of the adequacy of the technical training and proficiency of firm personnel.
 - Critical review of work done at every level of supervision.
 - Thorough review of the existing internal control structure.
 - Periodic review of a CPA firm's quality control procedures.
50. An accountant's report expressing an opinion on an entity's internal controls should
- Briefly explain the broad objectives and inherent limitations of internal control.
 - State that the study and evaluation of the internal controls was conducted in accordance with generally accepted auditing standards.
 - Clearly disclaim responsibility for the establishment and maintenance of the internal controls.
 - Include an opinion concerning management's assertions about whether the cost of correcting any material weaknesses would exceed the benefits of reducing the risk of errors and irregularities.

51. An accountant has been engaged to report on an entity's internal controls without performing an audit of the financial statements. What restrictions, if any, should the accountant place on the use of this report?

- This report should be restricted for use by management.
- This report should be restricted for use by the audit committee.
- This report should be restricted for use by a specified regulatory agency.
- The accountant does **not** need to place any restrictions on the use of this report.

52. Which of the following combinations results in a decrease in sample size in a sample for attributes?

	<i>Risk of overreliance</i>	<i>Tolerable rate</i>	<i>Expected population deviation rate</i>
a.	Increase	Decrease	Increase
b.	Decrease	Increase	Decrease
c.	Increase	Increase	Decrease
d.	Increase	Increase	Increase

53. What is an auditor's evaluation of a statistical sample for attributes when a test of 100 documents results in 4 deviations if tolerable rate is 5%, the expected population deviation rate is 3%, and the allowance for sampling risk is 2%?

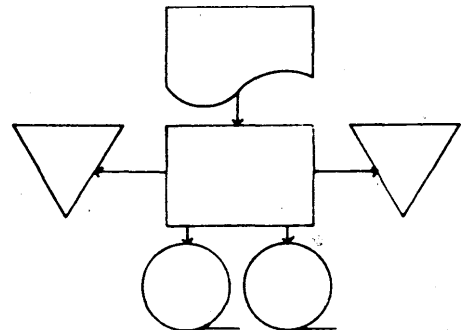
- Accept the sample results as support for planned reliance on the control because the tolerable rate less the allowance for sampling risk equals the expected population deviation rate.
- Modify planned reliance on the control because the sample deviation rate plus the allowance for sampling risk exceeds the tolerable rate.
- Modify planned reliance on the control because the tolerable rate plus the allowance for sampling risk exceeds the expected population deviation rate.
- Accept the sample results as support for planned reliance on the control because the sample deviation rate plus the allowance for sampling risk exceeds the tolerable rate.

54. A principal advantage of statistical methods of attribute sampling over nonstatistical methods is that they provide a scientific basis for planning the

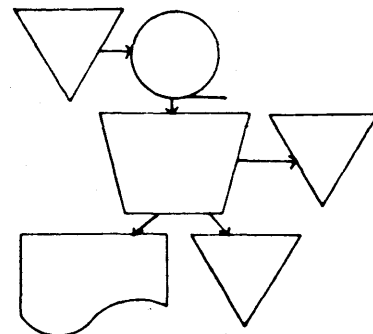
- Risk of overreliance.
- Tolerable rate.
- Expected population deviation rate.
- Sample size.

55. Which of the following symbolic representations indicates that new payroll transactions and the old payroll file have been used to prepare payroll checks, prepare a printed payroll journal, and generate a new payroll file?

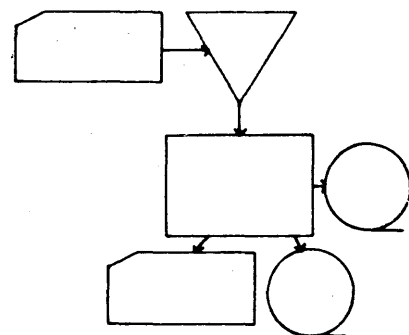
a.



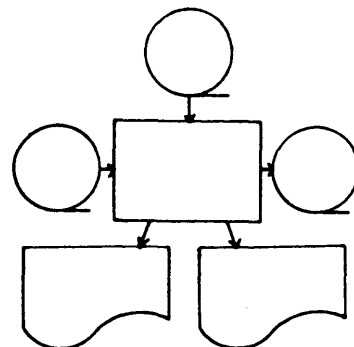
b.



c.



d.



56. The profession's ethical standards would most likely be considered to have been violated when a CPA

- a. Continued an audit engagement after the commencement of litigation against the CPA alleging excessive fees filed in a stockholders' derivative action.
- b. Represented to a potential client that the CPA's fees were substantially lower than the fees charged by other CPAs for comparable services.
- c. Issued a report on a financial forecast that omitted a caution regarding achievability.
- d. Accepted an MAS consultation engagement concerning data processing services for which the CPA lacked independence.

57. If requested to perform a review engagement for a nonpublic entity in which an accountant has an immaterial direct financial interest, the accountant is

- a. Independent because the financial interest is immaterial and, therefore, may issue a review report.
- b. Not independent and, therefore, may **not** be associated with the financial statements.
- c. Not independent and, therefore, may **not** issue a review report.
- d. Not independent and, therefore, may issue a review report, but may **not** issue an auditor's opinion.

58. Reportable conditions are matters that come to an auditor's attention, which should be communicated to an entity's audit committee because they represent

- a. Material irregularities or illegal acts perpetrated by high-level management.
- b. Significant deficiencies in the design or operation of the internal control structure.
- c. Flagrant violations of the entity's documented conflict-of-interest policies.
- d. Intentional attempts by client personnel to limit the scope of the auditor's field work.

59. Which of the following factors is most important concerning an auditor's responsibility to detect errors and irregularities?

- a. The susceptibility of the accounting records to intentional manipulations, alterations, and the misapplication of accounting principles.
- b. The probability that unreasonable accounting estimates result from unintentional bias or intentional attempts to misstate the financial statements.
- c. The possibility that management fraud, defalcations, and the misappropriation of assets may indicate the existence of illegal acts.
- d. The risk that mistakes, falsifications, and omissions may cause the financial statements to contain material misstatements.

60. If specific information comes to an auditor's attention that implies the existence of possible illegal acts that could have a material, but indirect effect on the financial statements, the auditor should next

- a. Apply audit procedures specifically directed to ascertaining whether an illegal act has occurred.
- b. Seek the advice of an informed expert qualified to practice law as to possible contingent liabilities.
- c. Report the matter to an appropriate level of management at least one level above those involved.
- d. Discuss the evidence with the client's audit committee, or others with equivalent authority and responsibility.

Number 2 (Estimated time — 15 to 25 minutes)

Bell, CPA, was engaged to audit the financial statements of Kent Company, a continuing audit client. Bell is about to audit Kent's payroll transactions. Kent uses an in-house payroll department to compute payroll data, and prepare and distribute payroll checks.

During the planning process, Bell determined that the inherent risk of overstatement of payroll expense is high. In addition, Bell obtained an understanding of the internal control structure and assessed control risk at the maximum level for payroll-related assertions.

Required:

Describe the audit procedures Bell should consider performing in the audit of Kent's payroll transactions to address the risk of overstatement. Do **not** discuss Kent's internal control structure.

Number 3 (Estimated time — 15 to 25 minutes)

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. They range from simple comparisons to the use of complex models involving many relationships and elements of data. They involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditors.

Required:

a. Describe the broad purposes of analytical procedures.

b. Identify the sources of information from which an auditor develops expectations.

c. Describe the factors that influence an auditor's consideration of the reliability of data for purposes of achieving audit objectives.

Number 4 (Estimated time — 15 to 25 minutes)

The following long-term debt working paper (indexed K-1) was prepared by client personnel and audited by AA, an audit assistant, during the calendar year 1988 audit of American Widgets, Inc., a continuing audit client. The engagement supervisor is reviewing the working papers thoroughly.

American Widgets, Inc. WORKING PAPERS December 31, 1988

Index	K-1	Date
Prepared By	AA	3/22/89
Approved By		

December 31, 1988

Lender	Interest Rate	Payment Terms	Collateral	Balance 12/31/87	1988 Borrowings	1988 Reductions	Balance 12/31/88	Interest paid to 12/25/88	Accrued Interest Payable 12/31/88	Comments
Φ First Commercial Bank	12%	Interest only on 25th of month, principal due in full 1/1/92; no prepayment penalty	Inventories	\$ 50,000 ✓	\$300,000 A 1/31/88	\$100,000 6/30/88	\$ 250,000 CX	12/25/88	\$2,500 NR	Dividend of \$80,000 paid 9/2/88 (W/P N-3) violates a provision of the debt agreement, which thereby permits lender to demand immediate payment; lender has refused to waive this violation
Φ Lender's Capital Corp.	Prime plus 1%	Interest only on last day of month, principal due in full 3/5/90	2nd Mortgage on Park St. Building	100,000 ✓	50,000 A 2/29/88	—	200,000 C	12/31/88	—	Prime rate was 8% to 9% during the year
Φ Gigantic Building & Loan Assoc.	12%	\$5,000 principal plus interest due on 5th of month, due in full 12/31/99	1st Mortgage on Park St. Building	720,000 ✓	—	60,000 6/30/88	660,000 C	12/5/88	5,642 R	Reclassification entry for current portion proposed (See RJE-3)
Φ J. Lott, majority stockholder	0%	Due in full 12/31/91	Unsecured	300,000 ✓	—	100,000 N 12/31/88	200,000 C	—	—	Borrowed additional \$100,000 from J. Lott on 1/7/89
				<u>\$1,170,000 ✓</u>	<u>\$350,000</u>	<u>\$260,000</u>	<u>\$1,310,000 T/B</u>		<u>\$8,142 T/B</u>	
				F	F	F	F		F	
Tickmark Legend										
F	Readied, foots correctly									
C	Confirmed without exception, W/P K-2									
CX	Confirmed with exception, W/P K-3									
NR	Does not recompute correctly									
A	Agreed to loan agreement, validated bank deposit ticket, and board of directors authorization, W/P W-7									
Φ	Agreed to canceled checks and lender's monthly statements									
N	Agreed to cash disbursements journal and canceled check dated 12/31/88, clearing 1/8/89									
T/B	Traced to working trial balance									
✓	Agreed to 12/31/87 working papers									
Φ	Agreed interest rate, term, and collateral to copy of note and loan agreement									
⊕	Agreed to canceled check and board of directors' authorization, W/P W-7									
Five year maturities (for disclosure purposes)										
Year end	12/31/89	\$ 60,000								
	12/31/90	260,000								
	12/31/91	260,000								
	12/31/92	310,000								
	12/31/93	60,000								
	Thereafter	360,000								
		<u>\$1,310,000</u>								
		F								
Interest costs from long-term debt										
	Interest expense for year									
	Average loan balance outstanding									
		\$ 281,333								
		\$1,406,667								
		R								
Overall conclusions										

Required: Identify the deficiencies in the working paper that the engagement supervisor should discover.

Number 5 (Estimated time — 15 to 25 minutes)

A CPA's audit working papers include the narrative description below of the cash receipts and billing portions of the internal control structure of Parktown Medical Center, Inc. Parktown is a small health care provider that is owned by a publicly held corporation. It employs seven salaried physicians, ten nurses, three support staff in a common laboratory, and three clerical workers. The clerical workers perform such tasks as reception, correspondence, cash receipts, billing, and appointment scheduling and are adequately bonded. They are referred to in the narrative as "office manager," "clerk #1," and "clerk #2."

NARRATIVE

Most patients pay for services by cash or check at the time services are rendered. Credit is not approved by the clerical staff. The physician who is to perform the respective services approves credit based on an interview. When credit is approved, the physician files a memo with the billing clerk (clerk #2) to set up the receivable from data generated by the physician.

The servicing physician prepares a charge slip that is given to clerk #1 for pricing and preparation of the patient's bill. Clerk #1 transmits a copy of the bill to clerk #2 for preparation of the revenue summary and for posting in the accounts receivable subsidiary ledger.

The cash receipts functions are performed by clerk #1, who receives cash and checks directly from patients and gives each patient a prenumbered cash receipt. Clerk #1 opens the mail and immediately stamps all checks "for deposit only" and lists cash and checks for deposit. The cash and checks are deposited daily by the office manager. The list of cash and checks together with the related remittance advices are forwarded by clerk #1 to clerk #2. Clerk #1 also serves as receptionist and performs general correspondence duties.

Clerk #2 prepares and sends monthly statements to patients with unpaid balances. Clerk #2 also prepares the cash receipts journal and is responsible for the accounts receivable subsidiary ledger. No other clerical employee is permitted access to the accounts receivable subsidiary ledger. Uncollectible accounts are written off by clerk #2 only after the physician who performed the respective services believes the account to be uncollectible and communicates the write-off approval to the office manager. The office manager then issues a write-off memo that clerk #2 processes.

The office manager supervises the clerks, issues write-off memos, schedules appointments for the doctors, makes bank deposits, reconciles bank statements, and performs general correspondence duties.

Additional services are performed monthly by a local accountant who posts summaries prepared by the clerks to the general ledger, prepares income statements, and files the appropriate payroll forms and tax returns. The accountant reports directly to the parent corporation.

Required:

Based only on the information in the narrative, describe the reportable conditions and one resulting misstatement that could occur and not be prevented or detected by Parktown's internal control structure concerning the cash receipts and billing function. Do **not** describe how to correct the reportable conditions and potential misstatements. Use the format illustrated below.

<i>Reportable condition</i>	<i>Potential misstatement</i>
There is no control to verify that fees are recorded and billed at authorized rates and terms.	Accounts receivable could be overstated and uncollectible accounts understated because of the lack of controls.

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WRITE YOUR 7-DIGIT CANDIDATE
NUMBER HERE. ONE DIGIT PER BOX.

EXAMINATION IN BUSINESS LAW

(Commercial Law)

November 3, 1989; 8:30 A.M. to 12:00 M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	Point Value	Estimated Minutes	
		Minimum	Maximum
No. 1	60	110	130
No. 2	10	15	20
No. 3	10	15	20
No. 4	10	15	20
No. 5	10	15	20
Totals	100	170	210

INSTRUCTIONS TO CANDIDATES

FAILURE TO FOLLOW THESE INSTRUCTIONS MAY HAVE AN ADVERSE EFFECT ON YOUR EXAMINATION GRADE

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.
2. Answer all objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since objective items are computer-graded, your comments and calculations associated with them are not considered. Be certain that you have entered your answers on the objective answer sheet before the examination time is up. **THE OBJECTIVE PORTION OF YOUR EXAMINATION WILL NOT BE GRADED IF YOU FAIL TO RECORD YOUR ANSWERS ON THE OBJECTIVE ANSWER SHEET.**
3. A CPA is continually confronted with the necessity of expressing opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.
4. **WRITE YOUR 7-DIGIT CANDIDATE NUMBER IN THE SPACE PROVIDED AT THE UPPER RIGHT HAND CORNER OF THIS PAGE.**
5. **YOU MUST HAND IN YOUR EXAMINATION BOOKLET AND ANSWER PAPERS BEFORE LEAVING THE EXAMINATION ROOM. YOUR EXAMINATION WILL NOT BE GRADED UNLESS YOUR EXAMINATION BOOKLET AND ANSWER PAPERS ARE HANDED IN.**
6. **IF YOU WANT YOUR EXAMINATION BOOKLET MAILED TO YOU, WRITE YOUR NAME AND ADDRESS IN THE SPACE PROVIDED ON THE BACK COVER PAGE AND PLACE 45 CENTS POSTAGE IN THE SPACE PROVIDED, UNLESS OTHERWISE INSTRUCTED. EXAMINATION BOOKLETS WILL BE DISTRIBUTED NO SOONER THAN THE DAY FOLLOWING THE ADMINISTRATION OF THIS EXAMINATION.**

*Prepared by the Board of Examiners of the American Institute of Certified Public Accountants
and adopted by the examining boards of all states, the District of Columbia, Guam,
Puerto Rico, and the Virgin Islands of the United States.*

Number 1 (Estimated time — 110 to 130 minutes)

Instructions

Select the best answer for each of the following items. Use a soft pencil, preferably No. 2, to blacken the appropriate circle on the separate printed answer sheet to indicate your answer. Mark only one answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

99. The text of the letter from Bridge Builders, Inc. to Allied Steel Co. follows:

We offer to purchase 10,000 tons of No. 4 steel pipe at today's quoted price for delivery two months from today. Your acceptance must be received in five days.

Bridge Builders intended to create a (an)

- a. Option contract.
- b. Unilateral contract.
- c. Bilateral contract.
- d. Joint contract.

Answer Sheet

99. (a) (b) (c) (d)

Items to be Answered

1. A principal and agent relationship requires a
 - a. Meeting of the minds and consent to act.
 - b. Specified consideration.
 - c. Written agreement.
 - d. Power of attorney.
2. A principal will not be liable to a third party for a tort committed by an agent
 - a. Unless the principal instructed the agent to commit the tort.
 - b. Unless the tort was committed within the scope of the agency relationship.
 - c. If the agency agreement limits the principal's liability for the agent's tort.
 - d. If the tort is also regarded as a criminal act.

3. Parc contracted with Furn Brothers Corp. to buy hotel furniture and fixtures on behalf of Global Motor House, a motel chain. Global instructed Parc to use Parc's own name and not to disclose to Furn that Parc was acting on Global's behalf. Who is liable to Furn on this contract?

	<u>Parc</u>	<u>Global</u>
a.	Yes	No
b.	No	Yes
c.	Yes	Yes
d.	No	No

4. A joint venture is a(an)
 - a. Association limited to no more than two persons in business for profit.
 - b. Enterprise of numerous co-owners in a nonprofit undertaking.
 - c. Corporate enterprise for a single undertaking of limited duration.
 - d. Association of persons engaged as co-owners in a single undertaking for profit.

5. Which of the following statements regarding a limited partner is(are) generally correct?

	<u>The limited partner is subject to personal liability for partnership debts</u>	<u>The limited partner has the right to take part in the control of the partnership</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

6. Gillie, Taft, and Dall are partners in an architectural firm. The partnership agreement is silent about the payment of salaries and the division of profits and losses. Gillie works full-time in the firm, and Taft and Dall each work half-time. Taft invested \$120,000 in the firm, and Gillie and Dall invested \$60,000 each. Dall is responsible for bringing in 50% of the business, and Gillie and Taft 25% each. How should profits of \$120,000 for the year be divided?

- a. Gillie \$60,000, Taft \$30,000, Dall \$30,000.
- b. Gillie \$40,000, Taft \$40,000, Dall \$40,000.
- c. Gillie \$30,000, Taft \$60,000, Dall \$30,000.
- d. Gillie \$30,000, Taft \$30,000, Dall \$60,000.

7. A partner's interest in specific partnership property is

	<u>Assignable to the partner's individual creditors</u>	<u>Subject to attachment by the partner's individual creditors</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

8. Harper transferred assets into a trust under which Drake is entitled to receive the income for life. Upon Drake's death, the remaining assets are to be paid to Neal. In 1988, the trust received rent of \$1,000, royalties of \$3,000, cash dividends of \$5,000, and proceeds of \$7,000 from the sale of stock previously received by the trust as a stock dividend. Both Drake and Neal are still alive. How much of the receipts should be distributed to Drake?

- a. \$ 4,000.
- b. \$ 8,000.
- c. \$ 9,000.
- d. \$16,000.

9. The mailbox rule generally makes acceptance of an offer effective at the time the acceptance is dispatched. The mailbox rule does **not** apply if

- a. Both the offeror and offeree are merchants.
- b. The offer proposes a sale of real estate.
- c. The offer provides that an acceptance shall not be effective until actually received.
- d. The duration of the offer is **not** in excess of three months.

10. For there to be consideration for a contract, there must be

- a. A bargained-for detriment to the promisor(ee) or a benefit to the promisee(or).
- b. A manifestation of mutual assent.
- c. Genuineness of assent.
- d. Substantially equal economic benefits to both parties.

11. Kent, a 16-year old, purchased a used car from Mint Motors, Inc. Ten months later, the car was stolen and never recovered. Which of the following statements is correct?

- a. The car's theft is a *de facto* ratification of the purchase because it is impossible to return the car.
- b. Kent may disaffirm the purchase because Kent is a minor.
- c. Kent effectively ratified the purchase because Kent used the car for an unreasonable period of time.
- d. Kent may disaffirm the purchase because Mint, a merchant, is subject to the UCC.

12. The Statute of Frauds

- a. Prevents the use of oral evidence to contradict the terms of a written contract.
- b. Applies to all contracts having consideration valued at \$500 or more.
- c. Requires the independent promise to pay the debt of another to be in writing.
- d. Applies to all real estate leases.

13. Unless the parties have otherwise agreed, an action for the breach of a contract within the UCC Sales Article must be commenced within

- a. Four years after the cause of action has accrued.
- b. Six years after the cause of action has accrued.
- c. Four years after the effective date of the contract.
- d. Six years after the effective date of the contract.

14. Bradford sold a parcel of land to Jones who promptly recorded the deed. Bradford then resold the land to Wallace. In a suit against Bradford by Wallace, recovery will be based on the theory of

- a. Bilateral mistake.
- b. Ignorance of the facts.
- c. Unilateral mistake.
- d. Fraud.

15. A party to a contract who seeks to rescind the contract because of that party's reliance on the unintentional but materially false statements of the other party will assert

- a. Reformation.
- b. Actual fraud.
- c. Misrepresentation.
- d. Constructive fraud.

16. Ward is attempting to introduce oral evidence in an action relating to a written contract between Ward and Weaver. Weaver has pleaded the parol evidence rule. Ward will be prohibited from introducing parol evidence if it relates to

- a. A modification made several days after the contract was executed.
- b. A change in the meaning of an unambiguous provision in the contract.
- c. Fraud in the inducement.
- d. An obvious error in drafting.

17. Jones owned an insurance policy on her life, on which she paid all the premiums. Smith was named the beneficiary. Jones died and the insurance company refused to pay the insurance proceeds to Smith. An action by Smith against the insurance company for the insurance proceeds will be

- a. Successful because Smith is a third party donee beneficiary.
- b. Successful because Smith is a proper assignee of Jones' rights under the insurance policy.
- c. Unsuccessful because Smith was **not** the owner of the policy.
- d. Unsuccessful because Smith did **not** pay any of the premiums.

Business Law

18. Moss entered into a contract to purchase certain real property from Shinn. Which of the following statements is not correct?

- a. If Shinn fails to perform the contract, Moss can obtain specific performance.
- b. The contract is nonassignable as a matter of law.
- c. The Statute of Frauds applies to the contract.
- d. Any amendment to the contract must be agreed to by both Moss and Shinn.

19. Nagel and Fields entered into a contract in which Nagel was obligated to deliver certain goods to Fields by September 10. On September 3, Nagel told Fields that Nagel had no intention of delivering the goods required by the contract. Prior to September 10, Fields may successfully sue Nagel under the doctrine of

- a. Promissory estoppel.
- b. Accord and satisfaction.
- c. Anticipatory repudiation.
- d. Substantial performance.

20. Burns borrowed \$240,000 from Dollar Bank as additional working capital for his business. Dollar required that the loan be collateralized to the extent of 20%, and that an acceptable surety for the entire amount be obtained. Surety Co. agreed to act as surety on the loan and Burns pledged \$48,000 of negotiable bearer bonds. Burns defaulted. Which of the following statements is correct?

- a. Dollar must first liquidate the collateral before it can proceed against Surety.
- b. Surety is liable in full immediately upon default by Burns, but will be entitled to the collateral upon satisfaction of the debt.
- c. Dollar must first proceed against Burns and obtain a judgment before it can proceed against the collateral.
- d. Surety may proceed against Burns for the full amount of the loan even if Surety settles with Dollar for a lower amount.

21. If a debtor defaults and the debtor's surety satisfies the obligation, the surety acquires the right of

- a. Subrogation.
- b. Primary lien.
- c. Indemnification.
- d. Satisfaction.

22. Rolf, an individual, filed a voluntary petition in bankruptcy. A general discharge in bankruptcy will be denied if Rolf

- a. Negligently made preferential transfers to certain creditors within 90 days of filing the petition.
- b. Unjustifiably failed to preserve Rolf's books and records.
- c. Filed a fraudulent federal income tax return two years prior to filing the petition.
- d. Obtained a loan by using financial statements that Rolf knew were false.

23. The filing of an involuntary petition in bankruptcy
- a. Allows creditors to continue their collection actions against the debtor while the bankruptcy action is pending.
 - b. Terminates liens associated with exempt property.
 - c. Stops the enforcement of a judgment lien against property in the bankruptcy estate.
 - d. Terminates all security interests in property in the bankruptcy estate.

24. Which of the following statements is correct concerning the voluntary filing of a petition in bankruptcy?

- a. The debtor must be insolvent.
- b. The petition may be filed by husband and wife jointly.
- c. If the debtor has 12 or more creditors, the debtor's unsecured claims must total at least \$5,000.
- d. If the debtor has fewer than 12 creditors, the debtor's unsecured claims must total at least \$5,000.

25. Filing a valid petition in bankruptcy acts as an automatic stay of actions to

	<u>Garnish the debtor's wages</u>	<u>Collect alimony from the debtor</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

26. Eagle Corp. is a general creditor of Dodd. Dodd filed a petition in bankruptcy under the liquidation provisions of the Bankruptcy Code. Eagle wishes to have the bankruptcy court either deny Dodd a general discharge or not have its debt discharged. The discharge will be granted and it will include Eagle's debt even if

- a. Dodd filed for and received a previous discharge in bankruptcy under the liquidation provisions within five years of the filing of the present petition.
- b. Eagle's debt is unscheduled.
- c. Eagle was a secured creditor not fully satisfied from the proceeds obtained on disposition of the collateral.
- d. Dodd unjustifiably failed to preserve the records from which Dodd's financial condition might be ascertained.

27. Which of the following assets would be included in a debtor's bankruptcy estate in a liquidation proceeding?
- Proceeds from a life insurance policy received 90 days after the petition was filed.
 - An inheritance received 270 days after the petition was filed.
 - Property from a divorce settlement received 365 days after the petition was filed.
 - Wages earned by the debtor after the petition was filed.

28. Which of the following unsecured debts of \$500 each would have the highest relative priority in the distribution of a bankruptcy estate in a liquidation proceeding?

- Tax claims of state and municipal governmental units.
- Liabilities to employee benefit plans arising from services rendered during the month preceding the filing of the petition.
- Claims owed to customers who gave deposits for the purchase of undelivered consumer goods.
- Wages earned by employees during the month preceding the filing of the petition.

29. As an alternative to bankruptcy liquidation, a business may reorganize under Chapter 11 of the Bankruptcy Code. Such a reorganization

- Requires the appointment of a trustee to administer the debtor organization.
- May be commenced by filing either a voluntary or involuntary petition.
- Never requires the appointment of a creditors' committee.
- May not be confirmed unless all creditors accept the plan.

30. Which of the following statements is correct regarding social security taxes?

- An individual who received net earnings from self-employment of \$40,000 and wages of \$40,000 in 1989 will be subject to social security taxes on \$80,000.
- Part of an employee's social security tax contribution qualifies for federal income tax purposes as a deduction from the employee's gross income.
- A self-employed person is subject to social security taxes based on that person's gross earnings from self-employment.
- An employer who fails to withhold and pay the employee's portion of social security taxes remains primarily liable for the employee's share.

31. Which of the following statements is not correct concerning federal unemployment insurance?

- Federal law provides general guidelines, standards, and requirements for the program.
- The states administer the benefit payments under the program.
- The program is funded by taxes imposed on employers and employees.
- The federal unemployment tax is calculated as a fixed percentage of each covered employee's salary up to a stated maximum.

32. An employee will generally be precluded from collecting full worker's compensation benefits when the injury is caused by

	<i>Noncompliance with the employer's rules</i>	<i>An intentional, self-inflicted action</i>
a.	No	No
b.	Yes	Yes
c.	No	Yes
d.	Yes	No

33. One of the elements necessary to recover damages if there has been a material misstatement in a registration statement filed pursuant to the Securities Act of 1933 is that the

- Plaintiff suffered a loss.
- Plaintiff gave value for the security.
- Issuer and plaintiff were in privity of contract with each other.
- Issuer failed to exercise due care in connection with the sale of the securities.

34. To be successful in a civil action under Section 11 of the Securities Act of 1933 concerning liability for a misleading registration statement, the plaintiff must prove

	<i>Defendant's intent to deceive</i>	<i>Plaintiff's reliance on the registration statement</i>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

35. An issuer making an offering under the provisions of Regulation A of the Securities Act of 1933 must file a(an)

- Prospectus.
- Offering statement.
- Shelf registration.
- Proxy.

36. Under the provisions of the Securities Exchange Act of 1934, a corporation whose common stock is listed on a national stock exchange

- Is prohibited from making private placement offerings.
- Must submit Form 10-K to the SEC except in those years in which the corporation has made a public offering.
- Must distribute copies of Form 10-K to its shareholders.
- Is subject to having the registration of its securities suspended or revoked.

37. Rule 504 of Regulation D of the Securities Act of 1933 provides issuers with an exemption from registration for certain small issues. Which of the following statements is correct?

- The rule allows sales to an unlimited number of investors.
- The rule requires certain financial information to be furnished to the investors.
- The issuer must offer the securities through general public advertising.
- The issuer is not required to file anything with the SEC.

38. Securities available under a private placement made pursuant to Regulation D of the Securities Act of 1933

- Cannot be subject to the payment of commissions.
- Must be sold to accredited institutional investors.
- Must be sold to fewer than 20 non-accredited investors.
- Cannot be the subject of an immediate unregistered reoffering to the public.

39. Which of the following types of securities are generally exempt from registration under the Securities Act of 1933?

	<i>Securities of nonprofit charitable organizations</i>	<i>Securities of savings and loan associations</i>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

40. A trade acceptance is an instrument drawn by a

- Seller obligating the seller or designee to make payment.
- Buyer obligating the buyer or designee to make payment.
- Seller ordering the buyer or designee to make payment.
- Buyer ordering the seller or designee to make payment.

41. For which of the following negotiable instruments is a bank **not** an acceptor?

- Cashier's check.
- Certified check.
- Certificate of deposit.
- Bank acceptance.

42. Which of the following is required to make an instrument negotiable?

- Stated date of issue.
- An indorsement by the payee.
- Stated location for payment.
- Payment only in legal tender.

43. Blare bought a house and provided the required funds in the form of a certified check from a bank. Which of the following statements correctly describes the legal liability of Blare and the bank?

- The bank has accepted; therefore, Blare is without liability.
- The bank has **not** accepted; therefore, Blare has primary liability.
- The bank has accepted, but Blare has secondary liability.
- The bank has **not** accepted, but Blare has secondary liability.

44. Silver Corp. sold 20 tons of steel to River Corp. with payment to be by River's check. The price of steel was fluctuating daily. Silver requested that the amount of River's check be left blank and Silver would fill in the current market price. River complied with Silver's request. Within two days, Silver received River's check. Although the market price of 20 tons of steel at the time Silver received River's check was \$80,000, Silver filled in the check for \$100,000 and negotiated it to Hatch Corp. Hatch took the check in good faith, without notice of Silver's act or any other defense, and in payment of an antecedent debt. River will

- Not be liable to Hatch, because the check was materially altered by Silver.
- Not be liable to Hatch, because Hatch failed to give value when it acquired the check from Silver.
- Be liable to Hatch for \$100,000.
- Be liable to Hatch, but only for \$80,000.

45. Which of the following factors is least important in determining whether a manufacturer is strictly liable in tort for a defective product?

- The negligence of the manufacturer.
- The contributory negligence of the plaintiff.
- Modifications to the product by the wholesaler.
- Whether the product caused injuries.

46. Cookie Co. offered to sell Distrib Markets 20,000 pounds of cookies at \$1.00 per pound, subject to certain specified terms for delivery. Distrib replied in writing as follows:

"We accept your offer for 20,000 pounds of cookies at \$1.00 per pound, weighing scale to have valid city certificate."

Under the UCC

- a. A contract was formed between the parties.
- b. A contract will be formed only if Cookie agrees to the weighing scale requirement.
- c. No contract was formed because Distrib included the weighing scale requirement in its reply.
- d. No contract was formed because Distrib's reply was a counteroffer.

47. DaGama bought a used boat from Magellan Marina, which disclaimed "any and all warranties" in connection with the sale. Magellan was unaware that the boat had been stolen from Colon. DaGama surrendered it to Colon when confronted with proof of the theft. DaGama sued Magellan. Who is likely to prevail and why?

- a. Magellan, because of the general disclaimer.
- b. Magellan, because it was unaware of the theft.
- c. DaGama, because the warranty of title has been breached.
- d. DaGama, because Magellan is a merchant.

48. Which of the following factors is most important in deciding who bears the risk of loss between merchants when goods are destroyed during shipment?

- a. The agreement of the parties.
- b. Whether the goods are perishable.
- c. Who has title at the time of the loss.
- d. The terms of applicable insurance policies.

49. On Monday, Wolfe paid Aston Co., a furniture retailer, \$500 for a table. On Thursday, Aston notified Wolfe that the table was ready to be picked up. On Saturday, while Aston was still in possession of the table, it was destroyed in a fire. Who bears the loss of the table?

- a. Wolfe, because Wolfe had title to the table at the time of loss.
- b. Aston, unless Wolfe is a merchant.
- c. Wolfe, unless Aston breached the contract.
- d. Aston, because Wolfe had not yet taken possession of the table.

50. Under the UCC Secured Transactions Article, for a security interest to attach, the

- a. Debtor must agree to the creation of the security interest.
- b. Creditor must properly file a financing statement.
- c. Debtor must be denied all rights in the collateral.
- d. Creditor must take and hold the collateral.

51. Mayker, Inc. and Oylco contracted to have Oylco be the exclusive provider of Mayker's fuel oil for three months. The stated price was subject to increases of up to a total of 10% if the market price increased. The market price rose 25% and Mayker tripled its normal order. Oylco seeks to avoid performance. Oylco's best argument in support of its position is that

- a. There was no meeting of the minds.
- b. The contract was unconscionable.
- c. The quantity was not definite and certain enough.
- d. Mayker ordered amounts of oil unreasonably greater than its normal requirements.

52. Under the UCC Sales Article, if a buyer wrongfully rejects goods, the aggrieved seller may

	<u>Resell the goods and sue for damages</u>	<u>Cancel the agreement</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

53. Perfection of a security interest permits the secured party to protect its interest by

- a. Avoiding the need to file a financing statement.
- b. Preventing another creditor from obtaining a security interest in the same collateral.
- c. Establishing priority over the claims of most subsequent secured creditors.
- d. Denying the debtor the right to possess the collateral.

54. Roth and Dixon both claim a security interest in the same collateral. Roth's security interest attached on January 1, 1989, and was perfected by filing on March 1, 1989. Dixon's security interest attached on February 1, 1989, and was perfected on April 1, 1989, by taking possession of the collateral. Which of the following statements is correct?

- a. Roth's security interest has priority because Roth perfected before Dixon perfected.
- b. Dixon's security interest has priority because Dixon's interest attached before Roth's interest was perfected.
- c. Roth's security interest has priority because Roth's security interest attached before Dixon's security interest attached.
- d. Dixon's security interest has priority because Dixon is in possession of the collateral.

55. Under the UCC Secured Transactions Article, if a debtor is in default under a payment obligation secured by goods, the secured party has the right to

	<i>Reduce the claim to a judgment</i>	<i>Sell the goods and apply the proceeds toward the debt</i>	<i>Take possession of the goods without judicial process</i>
a.	Yes	Yes	No
b.	Yes	No	Yes
c.	No	Yes	Yes
d.	Yes	Yes	Yes

56. A buyer of real estate who receives a title insurance policy will

- Take title free of all defects.
- Be able to transfer the policy to a subsequent buyer of the real estate.
- Not have coverage for title exceptions listed in the insurance policy.
- Not have coverage greater than the amount of any first mortgage.

57. If a borrower is in default under a purchase money mortgage loan, the

- Lender can file suit to have the borrower declared insolvent.
- Person who sold the real estate to the borrower can be forced to assume the mortgage debt.
- Lender may file suit for foreclosure.
- Lender may unilaterally obtain title without a foreclosure suit.

58. Ram Corp. owns a warehouse that has a fair market value of \$280,000. Area Bank holds a first mortgage and Public Finance holds a second mortgage on the warehouse. Ram has discontinued payments to Area and Public. As a result, Area, which has an outstanding mortgage of \$240,000, and Public, which has an outstanding mortgage of \$60,000, have foreclosed on their respective mortgages. If the warehouse is properly sold to Quincy at a judicial sale for \$280,000, after expenses,

- Public will receive \$40,000 out of the proceeds.
- Area will receive \$224,000 out of the proceeds.
- Public has a right of redemption after the judicial sale.
- Quincy will take the warehouse subject to the unsatisfied portion of any mortgage.

59. McArthur purchased a house for \$60,000. The house is insured for \$64,000 and the insurance policy has an 80% coinsurance provision. Storms caused \$12,000 worth of damage when the house had a fair market value of \$120,000. What maximum amount will McArthur recover from the insurance company?

- \$ 8,000.
- \$ 9,000.
- \$ 9,600.
- \$12,000.

60. To recover under a property insurance policy, an insurable interest must exist

	<i>When the policy is purchased</i>	<i>At the time of loss</i>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

Number 2 (Estimated time — 15 to 20 minutes)

On May 1, 1988, Mary Stein sold a commercial building to Sam Bean and Bean's son, Bob, as equal tenants in common. At the time of the sale, there was a recorded existing mortgage on the building in favor of Fale Bank. The mortgage and the note it secured were silent as to whether the entire amount outstanding on the loan would become due upon the sale of the building. Sam and Bob did not assume the mortgage and it was not paid off when they purchased the building.

On June 15, 1989, Sam died leaving a will naming his wife, Rita Bean, as the beneficiary of his entire estate, except for certain stocks which were to be transferred to a spendthrift trust created for the benefit of Bob. The will named Rita as the trustee and Bob as the sole beneficiary of the trust. The provision in the will creating the spendthrift trust stated in part that:

Payments and distributions to the beneficiary shall be made only to the beneficiary in person or upon his personal receipt, and no interest of the beneficiary in the income or principal of the trust estate shall be assignable in anticipation of payment, either by the voluntary or involuntary act of the beneficiary or by operation of law, or be liable in any way for the debts of the beneficiary.

Required:

- a. Discuss the personal liability of Sam Bean and Bob Bean, and the personal liability of Mary Stein, if there is a default on the mortgage to Fale and a foreclosure sale results in a deficiency.
- b. Discuss the effect Sam Bean's death will have on the ownership of the building.
- c. Discuss the major purposes/benefits of a spendthrift trust such as the one created by Sam Bean.
- d. Discuss whether
 1. A trust may generally be terminated by its beneficiaries; and
 2. The spendthrift trust created by Sam Bean could be terminated by Bob Bean.

Number 3 (Estimated time — 15 to 20 minutes)

Astor Inc. purchased the assets of Bell Corp. A condition of the purchase agreement required Bell to retain a CPA to audit Bell's financial statements. The purpose of the audit was to determine whether the unaudited financial statements furnished to Astor fairly presented Bell's financial position. Bell retained Salam & Co., CPAs, to perform the audit.

While performing the audit, Salam discovered that Bell's bookkeeper had embezzled \$500. Salam had some evidence of other embezzlements by the bookkeeper. However, Salam decided that the \$500 was immaterial and that the other suspected embezzlements did not require further investigation. Salam did not discuss the matter with Bell's management. Unknown to Salam, the bookkeeper had, in fact, embezzled large sums of cash from Bell. In addition, the accounts receivable were significantly overstated. Salam did not detect the overstatement because of Salam's inadvertent failure to follow its audit program.

Despite the foregoing, Salam issued an unqualified opinion on Bell's financial statements and furnished a copy of the audited financial statements to Astor. Unknown to Salam, Astor required financing to purchase Bell's assets and furnished a copy of Bell's audited financial statements to City Bank to obtain approval of the loan. Based on Bell's audited financial statements, City loaned Astor \$600,000.

Astor paid Bell \$750,000 to purchase Bell's assets. Within six months, Astor began experiencing financial difficulties resulting from the undiscovered embezzlements and overstated accounts receivable. Astor later defaulted on the City loan.

City has commenced a lawsuit against Salam based on the following causes of action:

- Constructive fraud
- Negligence

Required: In separate paragraphs, discuss whether City is likely to prevail on the causes of action it has raised, setting forth reasons for each conclusion.

Number 4 (Estimated time — 15 to 20 minutes)

Anker Corp., a furniture retailer, engaged Best & Co., CPAs, to audit Anker's financial statements for the year ended December 31, 1988. While reviewing certain transactions entered into by Anker during 1988, Best became concerned with the proper reporting of the following transactions:

- On September 8, 1988, Crisp Corp., a furniture manufacturer, signed and mailed a letter offering to sell Anker 50 pieces of furniture for \$9,500. The offer stated it would remain open until December 20, 1988. On December 5, 1988, Crisp mailed a letter revoking this offer. Anker received Crisp's revocation the following day. On December 12, 1988, Anker mailed its acceptance to Crisp, and Crisp received it on December 13, 1988.
- On December 6, 1988, Dix Corp. signed and mailed a letter offering to sell Anker a building for \$75,000. The offer stated that acceptance could only be made by certified mail, return receipt requested. On December 10, 1988, Anker telephoned Dix requesting that Dix keep the offer open until December 20, 1988 because it was reviewing Dix's offer. On December 12, 1988, Dix signed and mailed a letter to Anker indicating that it would hold the offer open until December 20, 1988. On December 19, 1988, Anker sent its acceptance to Dix by a private express mail courier. Anker's acceptance was received by Dix on December 20, 1988.

After reviewing the documents concerning the foregoing transactions, Best spoke with Anker's president who made the following assertions:

- The September 8, 1988 offer by Crisp was irrevocable until December 20, 1988, and therefore a contract was formed by Anker's acceptance on December 12, 1988.
- Dix's letter dated December 12, 1988 formed an option contract with Anker.
- Anker's acceptance on December 19, 1988 formed a contract with Dix.

Required: In separate paragraphs, discuss the assertions made by Anker's president. Indicate whether the assertions are correct and the reasons therefor.

Number 5 (Estimated time — 15 to 20 minutes)

On May 12, 1987, West purchased 6% of Ace Corp.'s outstanding \$3 cumulative preferred stock and 7% of Ace's outstanding common stock. These are the only two classes of stock authorized by Ace's charter. Both classes of stock are traded on a national stock exchange. Ace uses the calendar year for financial reporting purposes.

During 1987 and 1988, Ace neither declared dividends nor recorded dividends in arrears as a liability on its books. West was disturbed about this and, on February 8, 1989, sent a written demand to examine Ace's books and records to determine Ace's financial condition. Ace has refused to permit West to examine its books and records.

On May 8, 1989, West lost the stock certificate representing the shares of preferred stock. On May 9, 1989, West notified Ace of the lost stock certificate and requested that Ace issue a new stock certificate. West offered to file an indemnity bond with Ace and to fulfill any reasonable requests made by Ace. Although Ace has no knowledge that any other party has acquired the lost stock certificate, Ace refused to issue a new stock certificate or accept the indemnity bond.

As a result of the foregoing, West has made the following assertions:

- Ace should have recorded the dividends in arrears for 1987 and 1988 as a liability that, in effect, would treat West as a general creditor to the extent of the dividends in arrears.
- West is entitled to examine Ace's books and records.
- West is entitled to receive a new stock certificate to replace the lost stock certificate.

Required: In separate paragraphs, discuss West's assertions. Indicate whether such assertions are correct and the reasons therefor. Do not consider securities laws.

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WRITE YOUR 7-DIGIT CANDIDATE
NUMBER HERE. ONE DIGIT PER BOX.

EXAMINATION IN ACCOUNTING THEORY

(Theory of Accounts)

November 3, 1989; 1:30 P.M. to 5:00 P.M.

NOTE TO CANDIDATES: Suggested time allotments are as follows:

All questions are required:	<u>Point Value</u>	<u>Estimated Minutes</u>	
		<u>Minimum</u>	<u>Maximum</u>
No. 1	60	90	110
No. 2	10	15	25
No. 3	10	15	25
No. 4	10	15	25
No. 5	10	15	25
Totals	<u>100</u>	<u>150</u>	<u>210</u>

INSTRUCTIONS TO CANDIDATES

FAILURE TO FOLLOW THESE INSTRUCTIONS MAY HAVE AN ADVERSE EFFECT ON YOUR EXAMINATION GRADE

1. You must arrange the papers in numerical order of the questions. If more than one page is required for an answer, write "continued" at the bottom of the page. Number pages consecutively. For instance, if 12 pages are used for your answers, the objective answer sheet is page 1 and your other pages should be numbered 2 through 12.
2. Answer **all** objective-type items on the printed answer sheet provided for that purpose. It is to your advantage to attempt all questions even if you are uncertain of the answer. You are likely to get the highest score if you omit no answers. Since objective items are computer-graded, your comments and calculations associated with them are not considered. Be certain that you have entered your answers on the objective answer sheet before the examination time is up. **THE OBJECTIVE PORTION OF YOUR EXAMINATION WILL NOT BE GRADED IF YOU FAIL TO RECORD YOUR ANSWERS ON THE OBJECTIVE ANSWER SHEET.**
3. A CPA is continually confronted with the necessity of expressing opinions and conclusions in written reports in clear, unequivocal language. Although the primary purpose of the examination is to test the candidate's knowledge and application of the subject matter, the ability to organize and present such knowledge in acceptable written language may be considered by the examiners.
4. **WRITE YOUR 7-DIGIT CANDIDATE NUMBER IN THE SPACE PROVIDED AT THE UPPER RIGHT HAND CORNER OF THIS PAGE.**
5. **YOU MUST HAND IN YOUR EXAMINATION BOOKLET AND ANSWER PAPERS BEFORE LEAVING THE EXAMINATION ROOM. YOUR EXAMINATION WILL NOT BE GRADED UNLESS YOUR EXAMINATION BOOKLET AND ANSWER PAPERS ARE HANDED IN.**
6. **IF YOU WANT YOUR EXAMINATION BOOKLET MAILED TO YOU, WRITE YOUR NAME AND ADDRESS IN THE SPACE PROVIDED ON THE BACK COVER PAGE AND PLACE 45 CENTS POSTAGE IN THE SPACE PROVIDED, UNLESS OTHERWISE INSTRUCTED. EXAMINATION BOOKLETS WILL BE DISTRIBUTED NO SOONER THAN THE DAY FOLLOWING THE ADMINISTRATION OF THIS EXAMINATION.**

*Prepared by the Board of Examiners of the American Institute of Certified Public Accountants
and adopted by the examining boards of all states, the District of Columbia, Guam,
Puerto Rico, and the Virgin Islands of the United States.*

Number 1 (Estimated time — 90 to 110 minutes)

Instructions

Select the best answer for each of the following items relating to a variety of issues in accounting. Use a soft pencil, preferably No. 2, to blacken the appropriate circle on the separate printed answer sheet to indicate your answer. Mark only one answer for each item. Answer all items. Your grade will be based on the total number of correct answers.

The following is an example of the manner in which the answer sheet should be marked:

Item

99. The financial statement which summarizes the financial position of a company is the
- Income statement.
 - Balance sheet.
 - Statement of cash flows.
 - Retained earnings statement.

Answer Sheet

99. (a) ● (c) (d)

Items to be Answered

1. According to the FASB's conceptual framework, comprehensive income includes which of the following?

	<u>Gross margin</u>	<u>Operating income</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

2. Robin Co. has a marketable equity securities portfolio classified as noncurrent. None of the holdings enables Robin to exercise significant influence over an investee. The aggregate cost exceeds its aggregate market value. The decline is considered temporary and should be reported as a(an)

- Unrealized loss in the income statement.
- Realized loss in the income statement.
- Valuation allowance in the noncurrent liability section of the balance sheet.
- Valuation allowance in the asset section of the balance sheet.

3. An investor purchased a bond as a long-term investment on January 2. The investor's carrying value at the end of the first year would be highest if the bond was purchased at a

- Discount and amortized by the straight-line method.
- Discount and amortized by the effective interest method.
- Premium and amortized by the straight-line method.
- Premium and amortized by the effective interest method.

4. An investor in common stock received dividends in excess of the investor's share of investee's earnings subsequent to the date of the investment. How will the investor's investment account be affected by those dividends under each of the following accounting methods?

	<u>Cost method</u>	<u>Equity method</u>
a.	No effect	No effect
b.	Decrease	No effect
c.	No effect	Decrease
d.	Decrease	Decrease

5. On January 2, 1985, a company established a sinking fund in connection with an issue of bonds due in 1995. At December 31, 1988, the independent trustee held cash in the sinking fund account representing the annual deposits to the fund and the interest earned on those deposits. How should the sinking fund be reported in the company's classified balance sheet at December 31, 1988?

- The entire balance in the sinking fund account should appear as a noncurrent asset.
- The entire balance in the sinking fund account should appear as a current asset.
- The cash in the sinking fund should appear as a current asset.
- The accumulated deposits only should appear as a noncurrent asset.

6. On July 1, 1988, a company obtained a two-year 8% note receivable for services rendered. At that time the market rate of interest was 10%. The face amount of the note and the entire amount of the interest are due on June 30, 1990. Interest receivable at December 31, 1988, was

- 5% of the face value of the note.
- 4% of the face value of the note.
- 5% of the July 1, 1988, present value of the amount due June 30, 1990.
- 4% of the July 1, 1988, present value of the amount due June 30, 1990.

Examination Questions — November 1989

7. A method of estimating uncollectible accounts that emphasizes asset valuation rather than income measurement is the allowance method based on

- Aging the receivables.
- Direct write off.
- Gross sales.
- Credit sales less returns and allowances.

8. Shipping costs incurred by a consignor on transfer of goods to a consignee should be considered as

- Expense to the consignee.
- Expense to the consignor.
- Inventory cost to the consignee.
- Inventory cost to the consignor.

9. The UNO Company was formed on January 2, 1987, to sell a single product. Over a two-year period, UNO's acquisition costs have increased steadily. Physical quantities held in inventory were equal to three months sales at December 31, 1987, and zero at December 31, 1988. Assuming the periodic inventory system, the inventory cost method which reports the highest amount for each of the following is

	<u>Inventory</u> <u>December 31, 1987</u>	<u>Cost of sales</u> <u>1988</u>
a.	LIFO	FIFO
b.	LIFO	LIFO
c.	FIFO	FIFO
d.	FIFO	LIFO

10. The original cost of an inventory item is above the replacement cost and the net realizable value. The replacement cost is below the net realizable value less the normal profit margin. As a result, under the lower of cost or market method, the inventory item should be reported at the

- Net realizable value.
- Net realizable value less the normal profit margin.
- Replacement cost.
- Original cost.

11. Which of the following costs associated with an internally developed patent should be capitalized?

	<u>Research and</u> <u>development</u>	<u>Patent</u> <u>registration</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

12. On December 31, 1987, the New Bite Company had capitalized costs for a new computer software product with an economic life of four years. Sales for 1988 were ten percent of expected total sales of the software. At December 31, 1988, the software had a net realizable value equal to eighty percent of the capitalized cost. The unamortized cost reported on the December 31, 1988, balance sheet should be

- Net realizable value.
- Ninety percent of net realizable value.
- Seventy-five percent of capitalized cost.
- Ninety percent of capitalized cost.

13. A company receives an advance payment for special order goods that are to be manufactured and delivered within six months. The advance payment should be reported in the company's balance sheet as a

- Deferred charge.
- Contra asset account.
- Current liability.
- Noncurrent liability.

14. In a sale-leaseback transaction, the seller-lessee has retained the property. The gain on the sale should be recognized at the time of the sale-leaseback when the lease is classified as a(an)

	<u>Capital lease</u>	<u>Operating lease</u>
a.	Yes	Yes
b.	No	No
c.	No	Yes
d.	Yes	No

15. As a result of differences between depreciation for financial reporting purposes and tax purposes, the financial reporting basis of a company's plant assets exceeded the tax basis. Assuming the company had no other temporary differences, the company should report a

- Current tax asset.
- Current tax payable.
- Deferred tax asset.
- Deferred tax liability.

16. The present value of minimum lease payments should be used by the lessee in determining the amount of a lease liability under a lease classified by the lessee as a(an)

	<u>Capital lease</u>	<u>Operating lease</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

Accounting Theory

17. How would the carrying amount of a bond payable be affected by amortization of the following?

	<u>Discount</u>	<u>Premium</u>
a.	Increase	Increase
b.	Decrease	Decrease
c.	Increase	Decrease
d.	Decrease	Increase

18. Bonds payable issued with scheduled maturities at various dates are called

	<u>Serial bonds</u>	<u>Term bonds</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

19. When bonds payable are converted into common stock, any gain or loss would be recognized when using the

	<u>Book value method</u>	<u>Market value method</u>
a.	Yes	Yes
b.	No	Yes
c.	No	No
d.	Yes	No

20. A corporation was organized in January 1988 with authorized capital of \$10 par value common stock. On February 1, 1988, shares were issued at par for cash. On March 1, 1988, the corporation's attorney accepted 5,000 shares of the common stock in settlement for legal services with a fair value of \$60,000. Additional paid-in capital would increase on

	<u>February 1, 1988</u>	<u>March 1, 1988</u>
a.	Yes	No
b.	Yes	Yes
c.	No	No
d.	No	Yes

21. A corporation declared a dividend, a portion of which was liquidating. How would this declaration affect each of the following?

	<u>Additional paid-in capital</u>	<u>Retained earnings</u>
a.	Decrease	No effect
b.	Decrease	Decrease
c.	No effect	Decrease
d.	No effect	No effect

22. Ten thousand shares of \$10 par value common stock were issued initially at \$15 per share. Subsequently, one thousand of these shares were purchased as treasury stock at \$13 per share. The cost method of accounting for treasury stock is used. What is the effect of the purchase of the treasury stock on the amount reported in the balance sheet on each of the following?

	<u>Additional paid-in capital</u>	<u>Total stockholders' equity</u>
a.	No effect	No effect
b.	No effect	Decrease
c.	Decrease	No effect
d.	Decrease	Decrease

23. A corporation issued rights to its existing stockholders to purchase unissued shares of \$10 par value common stock for \$25 per share. The rights were issued for no consideration. Additional paid-in capital will be credited when the rights are

	<u>Issued</u>	<u>Exercised</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

24. On July 1, 1988, a partnership was formed by Johnson and Smith. Johnson contributed cash. Smith, previously a sole proprietor, contributed property other than cash including realty subject to a mortgage, which was assumed by the partnership. Smith's capital account at July 1, 1988, should be recorded at

- Smith's book value of the property at July 1, 1988.
- Smith's book value of the property less the mortgage payable at July 1, 1988.
- The fair value of the property less the mortgage payable at July 1, 1988.
- The fair value of the property at July 1, 1988.

25. Which of the following would be used in the calculation of the income recognized in the fourth and final year of a contract accounted for by the percentage-of-completion method?

	<u>Actual total costs</u>	<u>Income previously recognized</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

Examination Questions — November 1989

26. A bond issued on June 1, 1988, has interest payment dates of April 1 and October 1. Bond interest expense for the year ended December 31, 1988, would be for a period of

- a. Three months.
- b. Four months.
- c. Six months.
- d. Seven months.

27. Temporary differences arise when expenses are deductible for tax purposes.

	<u>After they are recognized in financial income</u>	<u>Before they are recognized in financial income</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

28. A company's convertible debt is both a common stock equivalent and dilutive in determining earnings per share. What would be the effect of consideration of the convertible debt in calculating

	<u>Primary earnings per share</u>	<u>Fully diluted earnings per share</u>
a.	Decrease	Decrease
b.	Increase	No effect
c.	No effect	Decrease
d.	Decrease	Increase

29. In a statement of cash flows, proceeds from issuing equity instruments should be classified as cash inflows from

- a. Lending activities.
- b. Operating activities.
- c. Investing activities.
- d. Financing activities.

30. In a statement of cash flows, payments to acquire debt instruments of other entities (other than cash equivalents) should be classified as cash outflows for

- a. Operating activities.
- b. Investing activities.
- c. Financing activities.
- d. Lending activities.

31. When a company changes the expected service life of an asset because additional information has been obtained, which of the following should be reported?

	<u>Cumulative effect of a change in accounting principle</u>	<u>Pro forma effects of retroactive application</u>
a.	No	Yes
b.	Yes	No
c.	Yes	Yes
d.	No	No

32. A business combination is accounted for properly as a pooling of interests. Which of the following expenses related to effecting the business combination should enter into the determination of net income of the combined corporation for the period in which the expenses are incurred?

	<u>Fees of finders and consultants</u>	<u>Registration fees</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

33. A supportive argument for the pooling of interests method of accounting for a business combination is that

- a. One company is clearly the dominant and continuing entity.
- b. Goodwill is generally a part of any acquisition.
- c. A portion of the total cost is assigned to individual assets acquired on the basis of their fair value.
- d. It was developed within the boundaries of the historical-cost system and is compatible with it.

34. An investment in marketable securities was accounted for by the cost method. These securities were distributed to stockholders as a property dividend in a nonreciprocal transfer. The dividend should be reported at the

- a. Fair value of the asset transferred or the recorded amount of the asset transferred, whichever is higher.
- b. Fair value of the asset transferred or the recorded amount of the asset transferred, whichever is lower.
- c. Fair value of the asset transferred.
- d. Recorded amount of the asset transferred.

35. For interim financial reporting, the computation of a company's second quarter provision for income taxes uses an effective tax rate expected to be applicable for the full fiscal year. The effective tax rate should reflect anticipated

	<u>Foreign tax rates</u>	<u>Available tax planning alternatives</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

Accounting Theory

36. In financial reporting for segments of a business enterprise, the operating profit or loss of a manufacturing segment includes

	<u>Interest expense</u>	<u>Portion of general corporate expense</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

37. Which of the following ratios should be used in evaluating the effectiveness with which the company uses its assets?

	<u>Receivables turnover</u>	<u>Dividend payout ratio</u>
a.	Yes	Yes
b.	No	No
c.	Yes	No
d.	No	Yes

38. A development stage enterprise should use the same generally accepted accounting principles that apply to established operating enterprises for

	<u>Deferral of costs</u>	<u>Expensing of costs when incurred</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

39. Personal financial statements should include which of the following statements?

	<u>Financial condition</u>	<u>Changes in net worth</u>	<u>Cash flows</u>
a.	No	Yes	Yes
b.	Yes	No	No
c.	Yes	Yes	No
d.	Yes	Yes	Yes

40. Which of the following items should be treated in the same manner in both combined financial statements and consolidated statements?

	<u>Different fiscal periods</u>	<u>Foreign operations</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

41. Direct labor cost is a

	<u>Conversion cost</u>	<u>Prime cost</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

42. In a job order cost system, the use of indirect materials previously purchased usually is recorded as a decrease in

- Stores control.
- Work-in-process control.
- Factory overhead control.
- Factory overhead applied.

43. Which of the following variances would be useful in calling attention to a possible short-term problem in the control of overhead costs?

	<u>Spending variance</u>	<u>Volume variance</u>
a.	No	No
b.	No	Yes
c.	Yes	No
d.	Yes	Yes

44. Actual sales values at the split-off point for joint products Y and Z are not known. For purposes of allocating joint costs to products Y and Z, the relative sales value at split-off method is used. An increase in the costs beyond split-off occurs for product Z, while those of product Y remain constant. If the selling prices of finished products Y and Z remain constant, the percentage of the total joint costs allocated to Product Y and Product Z would

- Decrease for Product Y and increase for Product Z.
- Decrease for Product Y and Product Z.
- Increase for Product Y and decrease for Product Z.
- Increase for Product Y and Product Z.

45. When a flexible budget is used, a decrease in production levels within a relevant range would

- Increase total fixed costs.
- Increase variable cost per unit.
- Decrease variable cost per unit.
- Decrease total costs.

46. In an income statement prepared as an internal report, total fixed costs normally would be shown separately under

	<u>Absorption costing</u>	<u>Variable costing</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

Examination Questions — November 1989

47. Breakeven analysis assumes that over the relevant range

- Unit variable costs are unchanged.
- Total fixed costs are nonlinear.
- Unit revenues are nonlinear.
- Total costs are unchanged.

48. The capital budgeting technique known as accounting rate of return uses

	<u>Revenue over life of project</u>	<u>Depreciation expense</u>
a.	No	Yes
b.	No	No
c.	Yes	No
d.	Yes	Yes

49. A company is analyzing the performance of responsibility centers. Controllable revenues would be included in the performance reports of which of the following types of responsibility centers?

	<u>Investment centers</u>	<u>Profit centers</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

50. A company is considering exchanging an old asset for a new asset. Ignoring income tax considerations, which of the following is economically relevant to the decision?

	<u>Original cost of old asset</u>	<u>Fair market value of old asset</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

51. The modified accrual basis of accounting is appropriate for which of the following fund categories of a county government?

	<u>Governmental</u>	<u>Proprietary</u>
a.	No	No
b.	No	Yes
c.	Yes	Yes
d.	Yes	No

52. The estimated revenues control account balance of a governmental fund type is eliminated when

- The budgetary accounts are closed.
- The budget is recorded.
- Property taxes are recorded.
- Appropriations are closed.

53. The budgetary fund balance reserved for encumbrances account of a governmental fund type is increased when

- A purchase order is approved.
- Supplies previously ordered are received.
- Appropriations are recorded.
- The budget is recorded.

54. Fixed assets used by a governmental unit should be accounted for in the

	<u>Capital projects fund</u>	<u>General fund</u>
a.	Yes	Yes
b.	Yes	No
c.	No	No
d.	No	Yes

55. Which of the following funds of a governmental unit uses the same basis of accounting as the enterprise fund?

- Nonexpendable trust funds.
- Expendable trust funds.
- Special revenue funds.
- Capital projects funds.

56. Fixed assets should be accounted for in the general fixed assets account group for the

	<u>Enterprise fund</u>	<u>Special revenue fund</u>
a.	Yes	No
b.	Yes	Yes
c.	No	Yes
d.	No	No

57. Customers' security deposits that cannot be spent for normal operating purposes were collected by a governmental unit and accounted for in the enterprise fund. A portion of the amount collected was invested in marketable debt securities and a portion in marketable equity securities. How would each portion be classified in the balance sheet?

	<u>Portion in marketable debt securities</u>	<u>Portion in marketable equity securities</u>
a.	Unrestricted asset	Restricted asset
b.	Unrestricted asset	Unrestricted asset
c.	Restricted asset	Unrestricted asset
d.	Restricted asset	Restricted asset

58. In a statement of support, revenue, and expenses and changes in fund balances of a voluntary health and welfare organization, depreciation expense should

- Be included as an element of expense.
- Be included as an element of other changes in fund balances.
- Be included as an element of support.
- Not be included.

Accounting Theory

59. Revenue from educational programs of a hospital normally would be included in

- a. Ancillary service revenue.
- b. Patient service revenue.
- c. Other nonoperating revenue.
- d. Other operating revenue.

60. The comprehensive annual financial report (CAFR) of a city should contain a combined statement of revenues, expenditures, and changes in fund balances for

	<u>Account groups</u>	<u>Proprietary funds</u>
a.	Yes	Yes
b.	Yes	No
c.	No	Yes
d.	No	No

Examination Questions — November 1989

Number 2 (Estimated time — 15 to 25 minutes)

Bristol Company purchased land as a site for construction of a factory. Outside contractors were engaged to:

- Construct the factory.
- Grade and pave a parking lot adjacent to the factory for the exclusive use of the factory workers.

Operations at the new location began during the year and normal factory maintenance costs were incurred after production began.

Required:

a. Distinguish between capital and revenue expenditures.

b. Indicate how expenditures for each of the following should be accounted for and reported by Bristol at the time incurred and in subsequent accounting periods.

1. Purchase of land.
2. Construction of factory.
3. Grading and paving parking lot.
4. Payment of normal factory maintenance costs.

Do not discuss capitalization of interest during construction in your response.

Number 3 (Estimated time 15 — 25 minutes)

Chester Company has the following contingencies:

- A threat of expropriation exists for one of its manufacturing plants located in a foreign country. Expropriation is deemed to be reasonably possible. Any compensation from the foreign government would be less than the carrying amount of the plant.
- Potential costs exist due to the discovery of a safety hazard related to one of its products. These costs are probable and can be reasonably estimated.
- One of its warehouses located at the base of a mountain could no longer be insured against rock-slide losses. No rock-slide losses have occurred.

Required:

a. How should Chester report the threat of expropriation of assets? Why?

b. How should Chester report the potential costs due to the safety hazard? Why?

c. How should Chester report the noninsurable rock-slide risk? Why?

Number 4 (Estimated time — 15 to 25 minutes)

Essex Company has a single-employer defined benefit pension plan, and a compensation plan for future vacations for its employees.

Required:

a. Define the interest cost component of net pension cost for a period. How should Essex determine its interest cost component of net pension cost for a period?

b. Define prior service cost. How should Essex account for prior service cost? Why?

c. What conditions must be met for Essex to accrue compensation for future vacations? What is the theoretical rationale for accruing compensation for future vacations?

Number 5 (Estimated time — 15 to 25 minutes)

Hillside Company had a loss during the year ended December 31, 1988 that is properly reported as an extraordinary item.

On July 1, 1988, Hillside committed itself to a formal plan for sale of a business segment. A loss is expected from the proposed sale. Segment operating losses were incurred continuously throughout 1988, and were expected to continue until final disposition in 1989. Costs were incurred in 1988 to relocate segment employees.

Required:

a. How should Hillside report the extraordinary item in its income statement? Why?

b. How should Hillside report the effect of the discontinued operations in its 1988 income statement?

c. How should Hillside report the costs that were incurred to relocate employees of the discontinued segment? Why?

Do not discuss earnings per share requirements.

ANSWERS TO EXAMINATION
ACCOUNTING PRACTICE — PART I

November 1, 1989; 1:30 to 6:00 p.m.

Answer 1 (10 points)

- | | |
|-------|-------|
| 1. c | 11. a |
| 2. a | 12. a |
| 3. c | 13. a |
| 4. d | 14. b |
| 5. b | 15. d |
| 6. b | 16. c |
| 7. a | 17. a |
| 8. d | 18. c |
| 9. a | 19. d |
| 10. d | 20. a |

Answer 2 (10 points)

- | | |
|-------|-------|
| 21. d | 31. b |
| 22. d | 32. a |
| 23. c | 33. c |
| 24. c | 34. b |
| 25. c | 35. a |
| 26. b | 36. b |
| 27. b | 37. c |
| 28. b | 38. b |
| 29. c | 39. d |
| 30. a | 40. d |

Answer 3 (10 points)

- | | |
|-------|-------|
| 41. c | 51. c |
| 42. b | 52. b |
| 43. b | 53. c |
| 44. a | 54. b |
| 45. c | 55. c |
| 46. a | 56. a |
| 47. c | 57. c |
| 48. d | 58. d |
| 49. d | 59. b |
| 50. b | 60. d |

The scores for the multiple choice questions were determined in accordance with the following scales:

Answer 1

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10

Answer 2

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10

Answer 3

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10	10	10

Answer 4 (10 points)

Candidate's No. _____
 State _____
 Question No. 4 Page _____

a.

Schedule 1

Nan Co.
**ANALYSIS OF CHANGES IN PROPERTY,
 PLANT, AND EQUIPMENT**
For the Year Ended December 31, 1988

	<i>Balance 12/31/87</i>	<i>Increase</i>	<i>Decrease</i>	<i>Balance 12/31/88</i>
Land	\$ 275,000	\$ —	\$ —	\$ 275,000
Buildings	2,800,000	1,875,000 [1]	—	4,675,000
Machinery and equipment	1,380,000	369,000 [2]	17,000	1,732,000
Automobiles and trucks	210,000	25,000	48,000	187,000
Leasehold improvements	432,000	—	—	432,000
Totals	\$5,097,000	\$2,269,000	\$65,000	\$7,301,000

Explanations of amounts:

[1] Construction cost of building	
Direct costs	\$1,095,000
Overhead costs	
Fixed (15,000 hours × \$25)	\$375,000
Variable (15,000 hours × \$27)	<u>405,000</u>
	780,000
	<u>\$1,875,000</u>
[2] Machinery and equipment purchased	
Invoice cost	\$325,000
Installation cost (concrete embedding)	18,000
Cost of gaining access to factory (\$19,000 + \$7,000)	<u>26,000</u>
Total acquisition cost	<u>\$369,000</u>

Answer 4 (continued)

b.1.

Nan Co.

SCHEDULE OF DEPRECIATION AND AMORTIZATION EXPENSE*For the Year Ended December 31, 1988***Buildings**

Carrying amount, 1/1/88 (\$2,800,000 - \$672,900)	\$2,127,100	
Building completed 1/6/88	<u>1,875,000</u>	
Total subject to depreciation	4,002,100	
150% declining balance $[(100\% \div 25) \times 1.5]$	<u>$\times 6\%$</u>	
Depreciation for 1988		<u><u>\$240,126</u></u>

Machinery and equipment

Balance, 1/1/88	\$1,380,000	
Straight-line $(100\% \div 10)$	<u>$\times 10\%$</u>	\$138,000
Purchased 7/1/88	369,000	
Straight-line $(10\% \times \frac{1}{12})$	<u>$\times 5\%$</u>	<u>18,450</u>
Depreciation for 1988		<u><u>\$156,450</u></u>

Automobiles and trucks

Carrying amount, 1/1/88 (\$210,000 - \$114,326)	\$ 95,674	
Deduct carrying amount, 1/1/88 on truck sold 9/30/88	<u>30,000</u>	
Amount subject to depreciation	65,674	
150% declining balance $[(100\% \div 5) \times 1.5]$	<u>$\times 30\%$</u>	\$ 19,702
Automobile purchased 8/30/88	25,000	
150% declining balance $(30\% \times \frac{1}{12})$	<u>$\times 10\%$</u>	2,500
Truck sold 9/30/88 — depreciation for 1988 $(1/1 \text{ to } 9/30/88) (\$30,000 \times 30\% \times \frac{1}{12})$		<u>6,750</u>
Depreciation for 1988		<u><u>\$ 28,952</u></u>

Leasehold improvements

Amortization for 1988 $(\$432,000 \div 12 \text{ years})$		<u><u>\$36,000</u></u>
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Answer 4 (continued)

Candidate's No. _____
 State _____
 Question No. 4 Page _____

b.2.

Schedule 2

Nan Co.
**ANALYSIS OF CHANGES IN ACCUMULATED
 DEPRECIATION AND AMORTIZATION**
For the Year Ended December 31, 1988

	<i>Balance 12/31/87</i>	<i>Increase</i>	<i>Decrease</i>	<i>Balance 12/31/88</i>
Buildings	\$ 672,900	\$240,126	\$ —	\$ 913,026
Machinery and equipment	367,500	156,450	14,025 [1]	509,925
Automobiles and trucks	114,326	28,952	24,750 [2]	118,528
Leasehold improvements	108,000	36,000	—	144,000
Totals	\$1,262,726	\$461,528	\$38,775	\$1,685,479

	<u>[1]</u>	<u>[2]</u>
Cost	\$17,000	\$48,000
Carrying Amount	2,975	23,250*
Accumulated Depreciation	<u>\$14,025</u>	<u>\$24,750</u>

*($\$30,000 - \$6,750$)

c.

Nan Co.
**GAIN ON DISPOSITION OF PROPERTY,
 PLANT, AND EQUIPMENT**
For the Year Ended December 31, 1988

	<u>Selling price</u>	<u>Carrying amount</u>	<u>Gain</u>
Sale of truck	\$23,500	\$23,250	250
Machine exchanged for debt	4,000	2,975	1,025
	<u>\$27,500</u>	<u>\$26,225</u>	<u>\$1,275</u>

Answer 5 (10 points)

Kern, Inc.
STATEMENT OF CASH FLOWS
For the Year Ended December 31, 1988
Increase (Decrease) in Cash

Cash flows from operating activities:		
Net income	\$305,000	
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	82,000	[1]
Amortization of patent	9,000	
Loss on sale of equipment	10,000	
Equity in income of Word Corp.	(30,000)	[2]
Gain on sale of marketable equity securities	(19,000)	
Decrease in allowance to reduce marketable equity securities to market	(15,000)	
Increase in accounts receivable	(35,000)	
Decrease in inventories	80,000	
Decrease in accounts payable and accrued liabilities	(115,000)	
Net cash provided by operating activities		\$272,000
Cash flows from investing activities:		
Sale of marketable equity securities	\$119,000	
Sale of equipment	18,000	
Purchase of equipment	(120,000)	
Net cash provided by investing activities		17,000
Cash flows from financing activities:		
Issuance of common stock	\$260,000	[3]
Cash dividend paid	(85,000)	
Payment on note payable	(300,000)	
Net cash used in financing activities		(125,000)
Net increase in cash		164,000
Cash at beginning of year		307,000
Cash at end of year		<u>\$471,000</u>

Explanations of Amounts:

[1] Depreciation		
Net increase in accumulated depreciation for year ended 12/31/88		\$ 65,000
Accumulated depreciation on equipment sold		<u>17,000</u>
Depreciation for 1988		<u>\$ 82,000</u>
[2] Equity in income of Word Corp.		
Reported net income for 1988		\$150,000
Kern's ownership		<u>× 20%</u>
Equity in income of Word. Corp. for 1988		<u>\$ 30,000</u>
[3] Issuance of common stock		
4/15/88, issued 20,000 shares for cash at \$13 per share		<u>\$260,000</u>

ANSWERS TO EXAMINATION
ACCOUNTING PRACTICE — PART II

November 2, 1989; 1:30 to 6:00 P.M.

Answer 1 (10 points)

- | | |
|-------|-------|
| 1. a | 11. d |
| 2. b | 12. c |
| 3. d | 13. d |
| 4. d | 14. c |
| 5. c | 15. b |
| 6. a | 16. b |
| 7. a | 17. a |
| 8. a | 18. b |
| 9. b | 19. b |
| 10. c | 20. b |

Answer 2 (10 points)

- | | |
|-------|-------|
| 21. c | 31. a |
| 22. c | 32. c |
| 23. c | 33. d |
| 24. c | 34. b |
| 25. a | 35. d |
| 26. d | 36. b |
| 27. b | 37. a |
| 28. b | 38. c |
| 29. d | 39. c |
| 30. a | 40. b |

Answer 3 (10 points)

- | | |
|-------|-------|
| 41. a | 51. d |
| 42. d | 52. a |
| 43. c | 53. a |
| 44. c | 54. b |
| 45. b | 55. d |
| 46. c | 56. a |
| 47. d | 57. c |
| 48. d | 58. c |
| 49. a | 59. b |
| 50. d | 60. c |

The scores for the multiple choice questions were determined in accordance with the following scales:

Answer 1

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	½	1	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10

Answer 2

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	½	1	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10

Answer 3

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	½	1	1½	2	2½	3	3½	4	4½	5	5½	6	6½	7	7½	8	8½	9	9½	10

Accounting Practice — Part II

Answer 4 (10 points)

Candidate's No. _____
 State _____
 Question No. 4 Page _____

Children's Agency
JOURNAL ENTRIES
For the Year Ended June 30, 1989

<i>Account Title</i>	<i>Current Fund</i>		<i>Land, Buildings, and Equipment Fund Dr. (Cr.)</i>	<i>Endowment Fund Dr. (Cr.)</i>
	<i>Unrestricted Dr. (Cr.)</i>	<i>Restricted Dr. (Cr.)</i>		
1. Pledges receivable	\$800,000		\$50,000	
Cash		\$95,000		\$1,000
Contributions	(800,000)	(95,000)	(50,000)	(1,000)
2. Cash	450,000		20,000	
Pledges receivable	(450,000)		(20,000)	
3. Cash	35,000			
Special events support	(12,000)			
Legacies and bequests	(10,000)			
Membership dues	(8,000)			
Investment revenue	(5,000)			
4. Medical services program	60,000			
Community information services program	15,000			
Vouchers payable	(75,000)			
5. Management and general services	150,000			
Fund raising services	200,000			
Vouchers payable	(350,000)			
6. Transfer to land, buildings, and equipment fund	18,000			
Cash	(18,000)			
Buildings and equipment			18,000	
Fund balance — expended			(18,000)	
7. Depreciation expense			15,000	
Accumulated depreciation			(15,000)	
Fund balance — expended			15,000	
Fund balance — unexpended			(15,000)	
Medical services program			4,000	
Community information services program			3,000	
Management and general services			6,000	
Fund raising services			2,000	
Depreciation expense			(15,000)	
8. Vouchers payable	330,000			
Cash	(330,000)			

Answer 5 (10 points)

a.

Fred and Laura Shaw
COMPUTATION OF TAXABLE INCOME
For the Year Ended December 31, 1988

<u>Income</u>			
Salary — Fred			\$80,000
Salary — Laura			15,000
Interest			100
Dividends			527
Social security benefits (½ of \$12,000)			6,000
Unemployment compensation			600
Long-term capital loss			
(Basis \$9,000; sales price \$2,500;			
allowable loss limited to \$3,000)			(3,000)
Adjusted gross income			<u>99,227</u>
<u>Itemized deductions</u>			
Taxes			
State income taxes (\$4,000 + \$120)	\$ 4,120		
Real estate taxes (\$3,000 + \$800)	<u>3,800</u>	\$ 7,920	
Interest (\$2,300 + \$1,800)		<u>4,100</u>	
Contributions (fair market value)		1,400	
Casualty loss			
Decline in market value after fire	16,000		
Less 10% of \$99,227	\$9,923		
“Floor”	<u>100</u>	<u>10,023</u>	5,977
Miscellaneous deductions			
Business travel	900		
Professional education	700		
Professional dues	150		
Tax return preparation fee	<u>250</u>		
Total	2,000		
Less 2% of \$99,227	<u>1,985</u>	<u>15</u>	
Total itemized deductions			<u>19,412</u>
Balance			79,815
Exemptions (3 × \$1,950)			<u>5,850</u>
TAXABLE INCOME			<u><u>\$73,965</u></u>

b.

COMPUTATION OF FEDERAL INCOME TAX OVERPAYMENT

Tax before payments on account		\$16,946
Payments on account		
Tax withheld (\$17,000 + \$2,800)	\$19,800	
Estimated tax (\$2,000 + \$43)	<u>2,043</u>	21,843
AMOUNT OVERPAID		<u><u>\$ 4,897</u></u>

ANSWERS TO EXAMINATION

AUDITING

November 2, 1989; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. d	11. c	21. d	31. c	41. b	51. d
2. d	12. c	22. c	32. a	42. a	52. c
3. a	13. b	23. a	33. a	43. a	53. b
4. b	14. b	24. d	34. a	44. b	54. d
5. b	15. d	25. b	35. c	45. d	55. d
6. a	16. b	26. c	36. d	46. d	56. c
7. c	17. c	27. c	37. b	47. d	57. c
8. a	18. c	28. a	38. a	48. b	58. b
9. d	19. c	29. a	39. c	49. b	59. d
10. a	20. d	30. d	40. b	50. a	60. a

The scores for the multiple choice questions were determined in accordance with the following scales:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24	25

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44	45

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	60	60	60	60	60

Answer 2 (10 points)

Bell should consider performing the following procedures in the audit of Kent's payroll transactions:

Select a sample of payments to employees from the payroll register and compare each selected transaction to the related documents and records examining

- Evidence in support of authorization of rate of pay.
- Evidence in support of time on which compensation was based, such as approved time cards or attendance records.
- Evidence in support of proper authorization of payroll withholdings.
- Evidence in support of payment, such as canceled payroll checks.
- Evidence in support of account distribution.
- The clerical accuracy of the transaction.
- The entry to the employee's records used to summarize employee compensation for payroll reporting purposes.

Obtain the payroll register for a selected period and

- Test the arithmetical accuracy of the payroll register.
- Determine whether payroll was approved in accordance with management's prescribed procedures.
- Trace totals per the register to postings in the general ledger.

Observe the distribution of payroll checks.

Review the accounting for unclaimed wages.

Observe a sample of employees in the performance of their duties.

Perform analytical procedures.

Auditing

Answer 3 (10 points)

a. Analytical procedures are used for these broad purposes:

- To assist the auditor in planning the nature, timing, and extent of other auditing procedures.
- As a substantive test to obtain evidential matter about particular assertions related to account balances or classes of transactions.
- As an overall review of the financial information in the final review stage of the audit.

b. An auditor's expectations are developed from the following sources of information:

- Financial information for comparable prior periods giving consideration to known changes.
- Anticipated results — for example, budgets, forecasts, and extrapolations.
- Relationships among elements of financial information within the period.
- Information regarding the industry in which the client operates.
- Relationships of financial information with relevant nonfinancial information.

c. The factors that influence an auditor's consideration of the reliability of data for purposes of achieving audit objectives are whether the

- Data were obtained from independent sources outside the entity or from sources within the entity.
- Sources within the entity were independent of those who are responsible for the amount being audited.
- Data were developed under a reliable system with adequate controls.
- Data were subjected to audit testing in the current or prior year.
- Expectations were developed using data from a variety of sources.

Answer 4 (10 points)

The working paper contains the following deficiencies:

1. The subject matter of the working paper is not properly indicated in the title.
2. There is no indication of any follow-up on the identified error in the accrued interest payable computation.
3. There is no indication whether the confirmation exception was resolved.
4. The loan with the unwaived violation of a provision of the debt agreement is misclassified as long-term.
5. The liability activities of Lender's Capital Corp. and the working paper totals do not crossfoot.
6. There is no indication of cross-referencing of the stockholder loan to the related party transactions working papers.
7. There is no investigation of the payment on the stockholder loan that was reborrowed soon after year-end.
8. There is no consideration of the need to impute interest expense on the 0% stockholder loan.
9. There is no indication that the dates under "interest paid to" were audited.
10. There is no indication that the unusually high average interest rate ($\$281,333/\$1,406,667 = 20\%$) was noted and investigated.
11. The working paper does not support the overall conclusions expressed.
12. The tickmark "R" is used but not explained in the tickmark legend.
13. There is no indication that the working paper was prepared by client personnel.

Answer 5 (10 points)

The reportable conditions and resulting misstatements, in addition to the example, that could occur and not be prevented or detected by Parktown's internal control structure concerning the cash receipts and billing functions include the following:

<i>Reportable condition</i>	<i>Potential misstatement</i>
The employees who perform services also are permitted to approve credit without an external credit check.	Uncollectible accounts expense could be understated and accounts receivable could be overstated because of the lack of an appropriate credit check.
There is no independent verification of the billing process.	Fees earned and accounts receivable may be understated because not all services performed might be reported for billing. or Fees earned and accounts receivable may be either overstated or understated because of the use of incorrect price or service data or because of mathematical errors.
The employees who approve credit also approve write-offs of uncollectible accounts.	Accounts receivable could be understated and uncollectible accounts expense overstated because write-offs of accounts receivable could be approved for accounts that are, in fact, collectible. or Accounts receivable could be overstated and uncollectible accounts expense understated because write-offs of accounts receivable might not be initiated for accounts that are uncollectible.
Credit is not granted on the basis of established limits.	Uncollectible accounts expense could be either understated or overstated because the lack of established credit limits may make it more difficult to identify uncollectible amounts.
The employee who initially handles cash receipts also prepares billings.	Fees earned and cash receipts or accounts receivable could be understated because of omitted or inaccurate billing.
The employee who makes bank deposits also reconciles bank statements.	The cash balance per books may be overstated because not all cash is deposited.
Uncollectible accounts are not determined on the basis of established criteria.	Uncollectible accounts expense could be either understated or overstated because of the lack of established write-off criteria.
Trial balances of the accounts receivable subsidiary ledger are not prepared independently of, or verified and reconciled to, the accounts receivable control account in the general ledger.	Any of fees earned, cash receipts, and uncollectible accounts expense could be either understated or overstated because of undetected differences between the subsidiary ledger and the general ledger. or Fees earned and cash receipts or accounts receivable could be understated because of failure to record billings, cash receipts, or write-offs accurately.

ANSWERS TO EXAMINATION

BUSINESS LAW

(Commercial Law)

November 3, 1989; 8:30 A.M. to 12:00 M.

Answer 1 (60 points)

1. a	11. b	21. a	31. c	41. c	51. d
2. b	12. c	22. b	32. c	42. d	52. a
3. c	13. a	23. c	33. a	43. c	53. c
4. d	14. d	24. b	34. d	44. c	54. a
5. d	15. c	25. b	35. b	45. a	55. d
6. b	16. b	26. c	36. d	46. a	56. c
7. d	17. a	27. a	37. a	47. c	57. c
8. c	18. b	28. d	38. d	48. a	58. a
9. c	19. c	29. b	39. a	49. d	59. a
10. a	20. b	30. d	40. c	50. a	60. c

The scores for the multiple choice questions were determined in accordance with the following scales:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22	23	24

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42	43	44

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	60	60	60	60

Answer 2 (10 points)

a. Sam Bean and Bob Bean will not be personally liable to Fale for the deficiency resulting from the foreclosure sale because they did not assume the mortgage but instead purchased the building subject to the mortgage. In the absence of a state statute to the contrary, Stein will be personally liable for the deficiency because Stein was not released from liability on the note and mortgage.

b. There is no right of survivorship feature in a tenancy in common and, therefore, Rita Bean will acquire Sam Bean's one-half interest in the building under her husband's will. Thus, Rita Bean will own a one-half interest in the building as a tenant in common with Bob Bean.

c. In general, the purposes and benefits of creating a spendthrift trust are to provide a fund for the maintenance of another (the beneficiary); protect the fund from the beneficiary's financial mismanagement and improvidence; prohibit the beneficiary from transferring the right to future trust income or principal; and prohibit the beneficiary's interest from being subjected to the claims of the beneficiary's creditors.

d.1. A trust may generally be terminated by the beneficiaries if all consent to the termination; all are legally competent to consent; and termination will not defeat a material purpose for which the trust was created.

2. The spendthrift trust created by Sam Bean cannot be terminated by Bob Bean because the major purpose of a spendthrift trust is to protect the beneficiary from mismanagement and improvidence. Thus, termination of the spendthrift trust would defeat the purpose for which it was created.

Answer 3 (10 points)

City is likely to prevail against Salam based on constructive fraud. To establish a cause of action for constructive fraud, City must prove that:

- Salam made a materially false statement of fact.
- Salam lacked a reasonable ground for belief that the statement was true. Constructive fraud may be inferred from evidence of gross negligence or recklessness.
- Salam intended another to rely on the false statement.
- City justifiably relied on the false statement.
- Such reliance resulted in damages or injury.

Under the facts of this case, Salam is likely to be liable to City based on constructive fraud. Salam made a materially false statement of fact by rendering an unqualified opinion on Bell's financial statements. Salam lacked a reasonable ground for belief that the financial statements were fairly presented by recklessly departing from the standards of due care in that it failed to investigate other embezzlements, despite having knowledge of at least one embezzlement, and did not notify Bell's management of the matter. Salam intended that others rely on the audited financial statements. City justifiably relied on the audited financial statements in deciding to loan Astor \$600,000 and damages resulted evidenced by Astor's default on the City loan.

City is not likely to prevail against Salam based on negligence. In order to establish a cause of action for negligence against Salam, City must prove that:

- Salam owed a legal duty to protect City.
- Salam breached that legal duty by failing to perform the audit with the due care or competence expected of members of the profession.
- City suffered actual losses or damages.
- Salam's failure to exercise due care proximately caused City to suffer damages.

The facts of this case establish that Salam was negligent by not detecting the overstatement of accounts receivable because of its inadvertent failure to follow its audit program. However, Salam will not be liable to City for negligence because Salam owed no duty to City. This is the case because Salam was not in privity of contract with City, and the financial statements were neither audited by Salam for the primary benefit of City, nor was City within a known and intended class of third party beneficiaries who were to receive the audited financial statements.

Answer 4 (10 points)

The president's assertion that the September 8, 1988 offer by Crisp was irrevocable until December 20, 1988, and that, therefore, a contract was formed by Anker's acceptance on December 12, 1988, is incorrect. Because the offer made by Crisp involves a transaction in goods, i.e. furniture, the UCC Sales Article applies. The UCC Sales Article provides that an offer by a merchant to buy or sell goods in a signed writing which by its terms gives assurance that it will be held open is not revocable, for lack of consideration, during the time stated or, if no time is stated, for a reasonable time, but in no event may such period of irrevocability exceed three months. Under the facts of this case, Crisp's offer was a firm offer that could not be revoked because the offer was made by Crisp, a merchant, concerning the kind of goods being sold (furniture); was in writing and signed by Crisp; and stated that it would remain open until December 20, 1988. Despite the provision that the offer will remain open until December 20, 1988, a firm offer remains irrevocable for a three-month period. Therefore, Crisp's letter of revocation on December 5, 1988 did not terminate the firm offer because the three-month period had not yet expired. The revocation was effective on December 8, 1988, when the three-month period expired. Therefore, Anker's attempted acceptance on December 12, 1988 did not form a contract with Crisp. Instead, Anker's attempted acceptance is likely to be treated as an offer.

The president's assertion that Dix's December 12, 1988 letter formed an option contract is incorrect. To form an option contract, where the subject matter is real estate, all of the elements necessary to form a contract must be met. In this case, Anker did not furnish any consideration in return for Dix's promise to keep the offer open until December 20, 1988; therefore, an option contract was not formed.

The president's assertion that Anker's acceptance on December 19, 1988 formed a contract with Dix is incorrect. In general, acceptance of an offer is effective when it is dispatched. If, however, an offer specifically stipulates the method of communication to be utilized by the offeree, the acceptance to be effective must conform to that method. Thus, an acceptance by another method of communication is ineffective and no contract is formed. Under the facts of this case, Anker's acceptance on December 19, 1988 by a private express mail courier is ineffective, despite Dix's receipt of the acceptance on December 20, 1988, because Dix's offer specifically stipulated that acceptance could only be made by certified mail, return receipt requested. Instead, Anker's attempted acceptance is likely to be treated as a counteroffer.

Answer 5 (10 points)

West's assertion that Ace should have recorded the dividends in arrears for 1987 and 1988 as a liability is incorrect. A shareholder of cumulative preferred stock is entitled to receive all dividend arrearages plus any dividends for the current year before any dividends may be distributed to the shareholders of common stock. However, preferred stock represents a contribution of capital, not a debt of the corporation, and until a dividend is declared, a shareholder of cumulative preferred stock is not a creditor of the corporation. Thus, Ace was correct in not classifying the dividend arrearages as a liability because a dividend was not declared by Ace's board of directors. Ace should disclose the dividend arrearages in notes to its financial statements.

West's assertion that West is entitled to examine Ace's books and records is correct. A shareholder, upon written demand, is entitled to examine, at reasonable times, the books and records of the corporation, so long as the examination is for a proper purpose (in good faith). If the corporation refuses to permit the examination, the shareholder may obtain a court order compelling access to the books and records.

West's assertion that West is entitled to receive a new stock certificate to replace the lost stock certificate is correct. Because the subject matter in this case is a stock certificate of a corporation, the UCC Investment Securities Article applies. Under that article, the stock certificate of Ace is classified as a certificated security because it is one of a class of Ace's shares that is represented by an instrument in West's name and is traded on a national securities exchange. If the owner of a certificated security claims that the security has been lost, the issuer shall issue a new certificated security, or, at the option of the issuer, an equivalent uncertificated security in place of the original security if the owner makes a request before the issuer has notice that the security has been acquired by a bona fide purchaser; files a sufficient indemnity bond with the issuer; and satisfies any other reasonable requirements imposed by the issuer. Based on the facts of this case, West is entitled to receive a new stock certificate because West requested that a new stock certificate be issued before Ace had notice the lost certificate was acquired by any other party; offered to file an indemnity bond with Ace; and offered to cooperate with any reasonable requests made by Ace.

ANSWERS TO EXAMINATION

ACCOUNTING THEORY

(Theory of Accounts)

November 3, 1989; 1:30 P.M. to 5:00 P.M.

Answer 1 (60 points)

1. d	11. a	21. b	31. d	41. c	51. d
2. d	12. c	22. b	32. a	42. a	52. a
3. d	13. c	23. a	33. d	43. c	53. a
4. d	14. b	24. c	34. c	44. c	54. c
5. a	15. d	25. a	35. d	45. d	55. a
6. b	16. b	26. d	36. c	46. b	56. c
7. a	17. c	27. c	37. c	47. a	57. d
8. d	18. c	28. a	38. a	48. d	58. a
9. c	19. b	29. d	39. c	49. c	59. d
10. b	20. d	30. b	40. c	50. c	60. d

The scores for the multiple choice questions were determined in accordance with the following scales:

Correct	0	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
Score	0	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20	21	22

Correct	21	22	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40
Score	23	24	25	26	27	28	29	30	31	32	33	34	35	36	37	38	39	40	41	42

Correct	41	42	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60
Score	43	44	45	46	47	48	49	50	51	52	53	54	55	56	57	58	59	60	60	60

Answer 2 (10 points)

a. Capital expenditures benefit future periods. Revenue expenditures benefit the current period only.

b. 1. The purchase price of the land should be capitalized. The land should be shown as a noncurrent asset on the balance sheet at its original cost and it is not subject to depreciation.

2. The cost of constructing the factory should be capitalized and depreciated over the expected life of the factory. The depreciation should be added to cost of inventory, via factory overhead, as goods are produced, and is expensed as cost of sales as goods are sold. The factory expenditures, net of accumulated depreciation, should be shown as a noncurrent asset on the balance sheet. Inventory should be reported as a current asset on the balance sheet, and cost of sales should be reported as an expense on the income statement.

3. The cost of grading and paving the parking lot should be capitalized and depreciated over the expected life of either the factory or parking lot, whichever is shorter. The depreciation should be added to cost of inventory, via factory overhead, as goods are produced, and is expensed as cost of sales as goods are sold. The land improvement expenditures, net of accumulated depreciation, should be shown as a noncurrent asset on the balance sheet. Inventory should be reported as a current asset on the balance sheet, and cost of sales should be reported as an expense on the income statement.

4. The cost of maintaining the factory once production has begun is a "revenue type" expenditure. However, since it is a factory cost, it should be added to cost of inventory, via factory overhead, as goods are produced, and is expensed as cost of sales as goods are sold. Inventory should be reported as a current asset on the balance sheet, and cost of sales should be reported as an expense on the income statement.

Answer 3 (10 points)

a. Chester should disclose the threat of expropriation of assets in the notes to the financial statements. Disclosure would include an estimate of the possible loss or an estimate of the range of loss. Accrual of a loss is inappropriate because the threat of expropriation is only reasonably possible.

b. Chester should report the potential costs due to the safety hazard by accruing a loss in the income statement and a liability in the balance sheet. Accrual is required because both of the following conditions are met:

- It is considered probable that a liability has been incurred.
- The amount of the loss can be reasonably estimated.

In addition, Chester should separately disclose in the notes to the financial statements the nature of the safety hazard.

c. Chester should not accrue a loss because an asset has not been impaired nor has a liability been incurred. Disclosure of the uninsured rock-slide risk, while permitted, is not required.

Answer 4 (10 points)

- a. The interest cost component of the net pension cost for a period is the increase in the projected benefit obligation due to the passage of time. Essex would determine its interest cost component by applying an assumed discount rate to the beginning projected benefit obligation.
- b. Prior service cost is the cost of retroactive benefits (increased benefits based on services rendered in prior periods) granted at the date of adoption or amendment of a pension plan. Prior service cost should be included in net pension cost during the future service periods of those employees active at the date of the pension plan adoption or amendment, as appropriate, who are expected to receive benefits under the pension plan. Prior service cost is incurred with the expectation that the employer will realize economic benefits in future periods.
- c. Essex must accrue compensation for future vacations if all of the following conditions are met:
- Essex's obligation relating to employees' rights to receive compensation for future vacations is attributable to employees' services already rendered.
 - The obligation relates to rights that vest or accumulate.
 - Payment of the vacation benefits is probable.
 - The amount can be reasonably estimated.

The theoretical rationale is that accruing compensation matches the cost of vacation benefits to the period in which services are rendered, and results in recognition of a measurable liability.

Answer 5 (10 points)

- a. Hillside should report the extraordinary item separately, net of applicable income taxes, below the continuing operations section in the income statement. Exclusion of extraordinary items from the results of continuing operations is intended to produce a measure of income from continuing operations that is useful in projecting future operating cash flows.
- b. Hillside should report the discontinued operations separately in the 1988 income statement immediately below income from continuing operations. Discontinued operations should be comprised of two categories, with each category reported net of income taxes:
- Loss from operations of the discontinued segment from the beginning of the year to the measurement date.
 - Loss on disposal of the discontinued segment, including the provision for operating losses during the phase-out period.
- c. Hillside should include the costs incurred to relocate employees in the loss on disposal of the discontinued segment in its 1988 income statement. These costs are a direct result of the commitment to dispose of its segment.

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INDEX — QUESTIONS

HOW TO USE THIS INDEX: This index presents examination question number references for the four sections of the CPA examination — Accounting Practice Parts I and II, Auditing, Business Law, and Accounting Theory. Each examination section has been organized according to its content specification outline, with questions indexed according to the areas and groups tested.

The question references listed in the right hand column are designated as follows: The question numbers are followed by the page number (in parentheses) in this book. The letter M following question numbers indicates a multiple choice item. For example, the reference 17M(N-4) means multiple choice item number 17 on page N-4; the reference 5(N-14) means essay or problem number 5 on page N-14. Note that, in the Accounting Practice section, no distinction has been made between Parts I and II.

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- D. Personal Holding Companies49M(N-23)
- E. Accumulated Earnings Tax
- F. Distributions52M(N-23)
- G. Tax-Free Incorporation53M(N-23)
- H. Reorganizations
- I. Liquidations and Dissolutions
- J. Formation of Partnership54M(N-23),55M(N-23)
- K. Basis of Partner's Interest
- L. Determination of Partner's Taxable Income and Partner's Elections
- M. Accounting Periods of Partnership and Partners
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- P. Distribution of Partnership Assets57M(N-24)
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- R. Types of Organizations58M(N-24)
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 - B. Conceptual Framework1M(N-51)
 - C. Basic Concepts and Accounting Principles2(N-58),3(N-58),4(N-58),5(N-58)
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 - E. Consolidated Financial Statements
 - F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts

- II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With GAAP.
 - A. Cash, Marketable Securities, and Investments2M(N-51),3M(N-51),4M(N-51),5M(N-51)
 - B. Receivables and Accruals6M(N-51),7M(N-52)
 - C. Inventories8M(N-52),9M(N-52),10M(N-52)
 - D. Property, Plant, and Equipment Owned or Leased2(N-58)
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 - B. Deferred Revenues14M(N-52)
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 - D. Capitalized Lease Liability16M(N-52)
 - E. Bonds Payable17M(N-53),18M(N-53),19M(N-53)
 - F. Contingent Liabilities and Commitments3(N-58)

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 - E. Stock Options, Warrants, and Rights23M(N-53)
 - F. Reorganization and Change in Entity
 - G. Partnerships24M(N-53)

- V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to GAAP.
 - A. Revenues and Gains25M(N-53)
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 - C. Provision for Income Tax27M(N-54)
 - D. Recurring Versus Nonrecurring Transactions and Events5(N-58)
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 - F. Earnings Per Share28M(N-54)

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I. Employee Benefits	4(N-58)
J. Analysis of Financial Statements	37M(N-55)
K. Development Stage Enterprises	38M(N-55)
L. Personal Financial Statements	39M(N-55)
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A. Nature of Cost Elements	41M(N-55)
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C. Standard Costing	43M(N-55)
D. Joint and By-Product Costing, Spoilage, Waste, and Scrap	44M(N-55)
E. Absorption and Variable Costing	46M(N-55)
F. Budgeting and Flexible Budgeting	45M(N-55)
G. Breakeven and Cost-Volume-Profit Analysis	47M(N-56)
H. Capital Budgeting Techniques	48M(N-56)
I. Performance Analysis	49M(N-56)
J. Other	50M(N-56)

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A. Conceptual Framework	51M(N-56)
B. Fund Accounting	52M(N-56),53M(N-56)
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D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations	60M(N-57)
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CONTRIBUTORS TO THIS UNIFORM CPA EXAMINATION

The Board of Examiners expresses its gratitude to the following contributors of questions appearing in the November 1989 examination.

*CONNIE L. CHILDERS

*LINDA COX

WALTER K. RUTLEDGE, *University of West Florida*

*JANICE TALIAFERRO

*Question submitted while a student of Professor Walter F. James, Washburn University of Topeka.

FUTURE CPA EXAMINATION DATES

1990 — May 2, 3, 4 November 7, 8, 9	1994 — May 4, 5, 6 November 2, 3, 4	1998 — May 6, 7, 8 November 4, 5, 6
1991 — May 8, 9, 10 November 6, 7, 8	1995 — May 3, 4, 5 November 1, 2, 3	1999 — May 5, 6, 7 November 3, 4, 5
1992 — May 6, 7, 8 November 4, 5, 6	1996 — May 8, 9, 10 November 6, 7, 8	2000 — May 3, 4, 5 November 1, 2, 3
1993 — May 5, 6, 7 November 3, 4, 5	1997 — May 7, 8, 9 November 5, 6, 7	

CONTENT SPECIFICATION OUTLINES



Content Specification Outlines

The original content specification outlines were adopted by the Board of Examiners in 1981, effective for the November 1983 examination. In 1984 the Board of Examiners modified the original content specification outlines in order to incorporate the information obtained from an AICPA practice analysis study.

The practice analysis study documented the major work segments performed by certified public accountants in the practice of public accountancy and identified the knowledge, skills, and abilities necessary to perform those work segments. These content specification outlines, effective for the May 1989 Uniform CPA Examination, are based upon the results of the practice analysis study.

Meaning and Use of Content Specification Outlines

The content specification outlines are divided into three levels—areas, groups, and topics, with the following outline notations:

- Areas by Roman numerals (I. Area)
- Groups by capital letters (A. Group)
- Topics by Arabic numbers (1. Topic)

The content specification outlines list the areas, groups, and topics to be tested, and also indicate the approximate percentage of the total test score devoted to each area. Some of the uses of the outlines will be —

- To assure consistent subject-matter coverage from one examination to the next.
- To assist candidates in preparing for the examination by indicating subjects which may be covered by the examination.
- To provide guidance to those who are responsible for preparing the examination in order to assure a balanced examination.
- To alert accounting educators about the subject matter considered necessary to prepare for the examination.

The relative weight given to each area is indicated by its approximate percentage allocation. The examination will sample from the groups and topics listed within each area in order to meet the approximate percentage allocation. Generally, the group title should be sufficient to indicate the subject matter to be covered. However, in certain instances, topics have been explicitly listed in order to clarify or limit the subject matter covered within a group.

No weight allocation is given for groups or topics. For example, if there are several groups within an area or several topics within a group, no inference should be drawn about the relative importance or weight to be given to these groups or topics on an examination.

Clear-cut distinctions about subject matter do not always exist. Thus, there may be overlapping of subjects in the four sections of the examination. For example, Auditing questions often require a knowledge of accounting theory and practice, as well as of auditing procedures. Also, Business Law questions may be set in an accounting or auditing environment, and answers may involve integration with accounting and auditing knowledge.

The content specification outlines are considered to be complete in respect to the subjects to be tested on an examination, including recent professional developments as they affect these subjects. Candidates should answer examination questions, developed from these outlines, in terms of the most recent developments, pronouncements, and standards in the accounting profession. When new subject matter is identified, the outlines will be amended to include it and this will be communicated to the profession.

Content Specification Outlines

Accounting Practice Section

The Accounting Practice section tests the candidates' ability to apply current conceptual accounting knowledge. The section includes the following: financial accounting concepts relating to financial reports, assets, liabilities, equity, income and expense, and other financial topics; cost/managerial accounting concepts of cost accumulation, planning, and control; not-for-profit and governmental accounting; and federal taxation.

In preparing for this section, candidates should study the pronouncements of the Financial Accounting Standards Board, Governmental Accounting Standards Board, Internal Revenue Code, Federal Tax Regulations, accounting textbooks, AICPA Audit and Accounting Guides, and other literature pertaining to accounting.

Accounting Practice—Content Specification Outline

- I. Presentation of Financial Statements or Worksheets (15 percent)
 - A. Balance Sheet
 - B. Income Statement
 - C. Statement of Cash Flows
 - D. Statement of Owners' Equity
 - E. Consolidated Financial Statements or Worksheets
- II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles (10 percent)
 - A. Cash, Marketable Securities, and Investments
 - 1. Cash
 - 2. Marketable Equity Securities
 - 3. Other Securities
 - 4. Investment in Bonds
 - 5. Investment in Stocks
 - 6. Sinking and Other Funds
 - B. Receivables and Accruals
 - 1. Accounts and Notes Receivable
 - 2. Affiliated Company Receivables
 - 3. Discounting of Notes
 - 4. Installment Accounts
 - 5. Interest and Other Accrued Income
 - 6. Allowance for Uncollectible Accounts
 - C. Inventories
 - 1. Acquisition Costs
 - 2. Costing Methods
 - 3. Valuation Methods
 - D. Property, Plant, and Equipment Owned or Leased
 - 1. Acquisition Costs
 - 2. Capital Versus Revenue Expenditures
 - 3. Depreciation, Amortization, and Depletion
 - 4. Leasehold Improvements
 - 5. Obsolescence and Write-downs
 - 6. Disposition
 - E. Intangibles and Other Assets
 - 1. Goodwill
 - 2. Patents

Content Specification Outlines

3. Other Intangibles
 4. Prepaid Expenses
 5. Deferred Income Tax Assets
 6. Prepaid Pension Cost
- III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles (10 percent)
- A. Payables and Accruals
 1. Accounts Payable
 2. Notes Payable
 3. Accrued Employees' Costs
 4. Interest and Other Accrued Expenses
 5. Unfunded Accrued Pension Cost
 6. Taxes Payable
 7. Deposits and Escrows
 - B. Deferred Revenues
 1. Unperformed Service Contracts
 2. Subscriptions or Tickets Outstanding
 3. Installment Sales
 4. Sale and Leaseback
 - C. Deferred Income Tax Liabilities
 1. Equity Method of Accounting for Investments
 2. Depreciation of Plant Assets
 3. Long-Term Construction Contracts
 4. Other Temporary Differences
 - D. Capitalized Lease Liability
 1. Measurement at Present Value
 2. Amortization
 - E. Bonds Payable
 1. Issue of Bonds
 2. Issue Costs
 3. Amortization of Discount or Premium
 4. Types of Bonds
 5. Conversion of Bonds
 6. Detachable Stock Warrants
 7. Retirement of Bonds
 - F. Contingent Liabilities and Commitments
- IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles (5 percent)
- A. Preferred and Common Stock
 1. Issued
 2. Outstanding
 3. Retirement of Stock
 4. Book Value Per Share
 5. Classification
 - B. Additional Paid-in Capital

Content Specification Outlines

C. Retained Earnings and Dividends

1. Prior Period Adjustments
2. Net Income
3. Cash Dividends
4. Property Dividends
5. Liquidating Dividends
6. Stock Dividends and Splits
7. Appropriations of Retained Earnings

D. Treasury Stock and Other Contra Accounts

1. Cost Method
2. Par Value Method
3. Restrictions on Acquisition of Treasury Stock
4. Other Contra Accounts

E. Stock Options, Warrants, and Rights

F. Reorganization and Change In Entity

1. Incorporation of an Unincorporated Enterprise
2. Business Combinations
3. Bankruptcy

G. Partnerships

1. Formation
2. Admission, Retirement, and Dissolution
3. Profit and Loss Distribution and Other Special Allocations

V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles (15 percent)

A. Revenues and Gains

1. Cash Versus Accrual Basis
2. At Time of Sale
3. At Completion of Production
4. During Production (percentage of completion)
5. Installment Method or Cost Recovery
6. Equity in Earnings of Investee
7. Interest
8. Dividends
9. Royalties
10. Rent
11. Disposal of Assets and Liquidation of Liabilities
12. Foreign Exchange
13. Unusual Gains

B. Expenses and Losses

1. Cost of Sales
2. General and Administrative
3. Selling
4. Financial (interest)
5. Depreciation, Amortization, and Depletion
6. Research and Development
7. Foreign Exchange
8. Uncollectible Accounts
9. Royalties
10. Rent
11. Compensation
12. Disposal of Assets and Liquidation of Liabilities
13. Unusual Losses

Content Specification Outlines

- C. Provision for Income Tax
 - 1. Current
 - 2. Deferred
- D. Recurring Versus Nonrecurring Transactions and Events
 - 1. Discontinued Operations
 - 2. Extraordinary Items
- E. Accounting Changes
- F. Earnings Per Share
- VI. Other Financial Topics (5 percent)
 - A. Disclosures in Notes to the Financial Statements
 - B. Accounting Policies
 - C. Nonmonetary Transactions
 - D. Interim Financial Statements
 - E. Historical Cost, Constant Dollar Accounting, and Current Cost
 - F. Gain Contingencies
 - G. Segments and Lines of Business
 - H. Employee Benefits
 - I. Analysis of Financial Statements
 - J. Development Stage Enterprises
 - K. Personal Financial Statements
 - L. Combined Financial Statements
- VII. Cost Accumulation, Planning, and Control (10 percent)
 - A. Nature of Cost Elements
 - 1. Direct Materials
 - 2. Direct Labor
 - 3. Overhead
 - B. Process and Job Order Costing
 - C. Standard Costing
 - D. Joint and By-Product Costing, Spoilage, Waste, and Scrap
 - E. Absorption and Variable Costing
 - F. Budgeting and Flexible Budgeting
 - G. Breakeven and Cost-Volume-Profit Analysis
 - H. Capital Budgeting Techniques
 - 1. Net Present Value
 - 2. Internal Rate of Return
 - 3. Payback Period
 - 4. Accounting Rate of Return
 - I. Performance Analysis
 - 1. Return on Investment
 - 2. Residual Income
 - 3. Controllable Revenue and Costs
 - J. Other
 - 1. Regression and Correlation Analysis
 - 2. Economic Order Quantity
 - 3. Probability Analysis
 - 4. Variance Analysis
 - 5. Differential Cost Analysis
 - 6. Product Pricing

Content Specification Outlines

VIII. Not-for-Profit and Governmental Accounting (10 percent)

A. Fund Accounting

1. Fund Balance
2. Estimated Revenues
3. Appropriations
4. Encumbrances
5. Fund Balance Reserved for Encumbrances
6. Revenues
7. Expenditures

B. Types of Funds and Account Groups

1. General Fund
2. Special Revenue Funds
3. Debt Service Funds
4. Capital Projects Funds
5. Enterprise Funds
6. Internal Service Funds
7. Trust and Agency Funds
8. General Fixed Assets Account Group
9. General Long-Term Debt Account Group
10. Endowment and Quasi-Endowment Funds
11. Restricted and Unrestricted Funds
12. Property Funds

C. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

D. Various Types of Not-for-Profit and Governmental Organizations

1. Local and State Governments
2. Educational Institutions
3. Hospitals
4. Charitable, Religious, and Other Organizations

IX. Federal Taxation—Individuals, Estates, and Trusts (10 percent)

A. Inclusions for Gross Income and Adjusted Gross Income

1. Reporting Basis of Taxpayer—Cash, Accrual, or Modified
2. Compensation for Services
3. Business Income
4. Interest
5. Rent and Royalties
6. Dividends
7. Alimony
8. Capital Gains and Losses
9. Miscellaneous Income

B. Exclusions and Adjustments to Arrive at Adjusted Gross Income

C. Gain or Loss on Property Transactions

1. Character
2. Recognition
3. Basis and Holding Period

D. Deductions from Adjusted Gross Income

E. Filing Status and Exemptions

F. Tax Computations and Credits

G. Statute of Limitations

Content Specification Outlines

1. Claims for Refund
 2. Assessments
- H. Estate and Gift Taxation and Income Taxation of Estates and Trusts
- X. Federal Taxation—Corporations, Partnerships, and Exempt Organizations (10 percent)
- Corporations
- A. Determination of Taxable Income or Loss
1. Determination of Gross Income, Including Capital Gains and Losses
 2. Deductions from Gross Income
 3. Reconciliation of Taxable Income and Book Income
 4. Reconciliation of Opening and Closing Retained Earnings
 5. Consolidations
- B. Tax Computations and Credits
- C. S Corporations
- D. Personal Holding Companies
- E. Accumulated Earnings Tax
- F. Distributions
- G. Tax-Free Incorporation
- H. Reorganizations
- I. Liquidations and Dissolutions
- Partnerships
- J. Formation of Partnership
1. Contribution of Capital
 2. Contribution of Services
- K. Basis of Partner's Interest
1. Acquired Through Contribution
 2. Interest Acquired From Another Partner
 3. Holding Period of Partner's Interest
 4. Adjustments to Basis of Partner's Interest
- L. Determination of Partner's Taxable Income and Partner's Elections
- M. Accounting Periods of Partnership and Partners
- N. Partner Dealing With Own Partnership
1. Sales and Exchanges
 2. Guaranteed Payments
- O. Treatment of Liabilities
- P. Distribution of Partnership Assets
1. Current Distributions
 2. Distributions in Complete Liquidation
 3. Basis of Distributed Property
- Q. Termination of Partnership
1. Change in Membership
 2. Merger or Split-up of Partnership
 3. Sale or Exchange of Partnership Interest
 4. Payments to a Retiring Partner
 5. Payments to a Deceased Partner's Successor

Content Specification Outlines

Exempt Organizations

- R. Types of Organizations
- S. Requirements for Exemption
- T. Unrelated Business Income

Accounting Theory Section

The Accounting Theory section tests the candidates' conceptual knowledge of accounting. This knowledge includes a rather wide assortment of ideas variously described as assumptions, axioms, standards, postulates, conventions, principles, rules, and objectives. Ideas that have received substantial authoritative support are referred to as generally accepted accounting principles. The section includes the following: financial accounting concepts relating to general principles, assets, liabilities, equity, income and expense, and other financial topics; cost/managerial accounting concepts of cost accumulation, planning, and control; and not-for-profit and governmental accounting.

In preparing for this section, candidates should study the pronouncements of the Financial Accounting Standards Board, Governmental Accounting Standards Board, accounting textbooks, AICPA Audit and Accounting Guides, and other literature pertaining to accounting. Answers should be in accord with current accounting theory and not necessarily with accounting methods and practices promulgated by governmental agencies, such as the Internal Revenue Service and the Securities and Exchange Commission (unless these methods and practices are specifically required or are vital to a complete discussion of the issues involved).

Accounting Theory—Content Specification Outline

- I. General Concepts, Principles, Terminology, Environment, and Other Professional Standards (15 percent)
 - A. Authority of Pronouncements (substantial authoritative support—GAAP)
 - B. Conceptual Framework
 - C. *Basic Concepts and Accounting Principles*
 - D. Nature and Purpose of Basic Financial Statements
 - E. Consolidated Financial Statements
 - F. Historical Cost, Constant Dollar, Current Cost, and Other Accounting Concepts
- II. Measurement, Valuation, Realization, and Presentation of Assets in Conformity With Generally Accepted Accounting Principles (15 percent)
 - A. Cash, Marketable Securities, and Investments
 - 1. Cash
 - 2. Marketable Equity Securities
 - 3. Other Securities
 - 4. Investment in Bonds
 - 5. Investment in Stocks
 - 6. Sinking and Other Funds
 - B. Receivables and Accruals
 - 1. Accounts and Notes Receivable
 - 2. Affiliated Company Receivables
 - 3. Discounting of Notes
 - 4. Installment Accounts
 - 5. Interest and Other Accrued Income
 - 6. Allowance for Uncollectible Accounts
 - C. Inventories
 - 1. Acquisition Costs
 - 2. Costing Methods
 - 3. Valuation Methods

Content Specification Outlines

D. Property, Plant, and Equipment Owned or Leased

1. Acquisition Costs
2. Capital Versus Revenue Expenditures
3. Depreciation, Amortization, and Depletion
4. Leasehold Improvements
5. Obsolescence and Write-downs
6. Disposition

E. Intangibles and Other Assets

1. Goodwill
2. Patents
3. Other Intangibles
4. Prepaid Expenses
5. Deferred Income Tax Assets
6. Prepaid Pension Cost

III. Valuation, Recognition, and Presentation of Liabilities in Conformity With Generally Accepted Accounting Principles (10 percent)

A. Payables and Accruals

1. Accounts Payable
2. Notes Payable
3. Accrued Employees' Costs
4. Interest and Other Accrued Expenses
5. Unfunded Accrued Pension Cost
6. Taxes Payable
7. Deposits and Escrows

B. Deferred Revenues

1. Unperformed Service Contracts
2. Subscriptions or Tickets Outstanding
3. Installment Sales
4. Sale and Leaseback

C. Deferred Income Tax Liabilities

1. Equity Method of Accounting for Investments
2. Depreciation of Plant Assets
3. Long-Term Construction Contracts
4. Other Temporary Differences

D. Capitalized Lease Liability

1. Measurement at Present Value
2. Amortization

E. Bonds Payable

1. Issue of Bonds
2. Issue Costs
3. Amortization of Discount or Premium
4. Types of Bonds
5. Conversion of Bonds
6. Detachable Stock Warrants
7. Retirement of Bonds

F. Contingent Liabilities and Commitments

Content Specification Outlines

- IV. Ownership Structure, Presentation, and Valuation of Equity Accounts in Conformity With Generally Accepted Accounting Principles (5 percent)
 - A. Preferred and Common Stock
 - 1. Issued
 - 2. Outstanding
 - 3. Retirement of Stock
 - 4. Book Value Per Share
 - 5. Classification
 - B. Additional Paid-in Capital
 - C. Retained Earnings and Dividends
 - 1. Prior Period Adjustments
 - 2. Net Income
 - 3. Cash Dividends
 - 4. Property Dividends
 - 5. Liquidating Dividends
 - 6. Stock Dividends and Splits
 - 7. Appropriations of Retained Earnings
 - D. Treasury Stock and Other Contra Accounts
 - 1. Cost Method
 - 2. Par Value Method
 - 3. Restrictions on Acquisition of Treasury Stock
 - 4. Other Contra Accounts
 - E. Stock Options, Warrants, and Rights
 - F. Reorganization and Change in Entity
 - 1. Incorporation of an Unincorporated Enterprise
 - 2. Business Combinations
 - 3. Bankruptcy
 - G. Partnerships
 - 1. Formation
 - 2. Admission, Retirement, and Dissolution
 - 3. Profit or Loss Distribution and Other Special Allocations
- V. Measurement and Presentation of Income and Expense Items, Their Relationship to Matching and Periodicity, and Their Relationship to Generally Accepted Accounting Principles (20 percent)
 - A. Revenues and Gains
 - 1. Cash Versus Accrual Basis
 - 2. At Time of Sale
 - 3. At Completion of Production
 - 4. During Production (percentage of completion)
 - 5. Installment Method or Cost Recovery
 - 6. Equity in Earnings of Investee
 - 7. Interest
 - 8. Dividends
 - 9. Royalties
 - 10. Rent
 - 11. Disposal of Assets and Liquidation of Liabilities
 - 12. Foreign Exchange
 - 13. Unusual Gains
 - B. Expenses and Losses
 - 1. Cost of Sales
 - 2. General and Administrative

Content Specification Outlines

3. Selling
 4. Financial (interest)
 5. Depreciation, Amortization, and Depletion
 6. Research and Development
 7. Foreign Exchange
 8. Uncollectible Accounts
 9. Royalties
 10. Rent
 11. Compensation
 12. Disposal of Assets and Liquidation of Liabilities
 13. Unusual Losses
- C. Provision for Income Tax
1. Current
 2. Deferred
- D. Recurring Versus Nonrecurring Transactions and Events
1. Discontinued Operations
 2. Extraordinary Items
- E. Accounting Changes
- F. Earnings Per Share
- VI. Other Financial Topics (15 percent)
- A. Statement of Cash Flows
 - B. Accounting Policies
 - C. Accounting Changes
 - D. Nonmonetary Transactions
 - E. Business Combinations
 - F. Interim Financial Statements
 - G. Gain Contingencies
 - H. Segments and Lines of Business
 - I. Employee Benefits
 - J. Analysis of Financial Statements
 - K. Development Stage Enterprises
 - L. Personal Financial Statements
 - M. Combined Financial Statements
- VII. Cost Accumulation, Planning, and Control (10 percent)
- A. Nature of Cost Elements
1. Direct Materials
 2. Direct Labor
 3. Overhead
- B. Process and Job Order Costing
- C. Standard Costing
- D. Joint and By-Product Costing, Spoilage, Waste, and Scrap
- E. Absorption and Variable Costing
- F. Budgeting and Flexible Budgeting
- G. Breakeven and Cost-Volume-Profit Analysis
- H. Capital Budgeting Techniques
1. Net Present Value
 2. Internal Rate of Return
 3. Payback Period
 4. Accounting Rate of Return

Content Specification Outlines

I. Performance Analysis

1. Return on Investment
2. Residual Income
3. Controllable Revenue and Costs

J. Other

1. Regression and Correlation Analysis
2. Economic Order Quantity
3. Probability Analysis
4. Variance Analysis
5. Differential Cost Analysis
6. Product Pricing

VIII. Not-for-Profit and Governmental Accounting (10 percent)

A. Conceptual Framework

B. Fund Accounting

1. Fund Balance
2. Estimated Revenues
3. Appropriations
4. Encumbrances
5. Fund Balance Reserved for Encumbrances
6. Revenues
7. Expenditures

C. Types of Funds and Account Groups

1. General Fund
2. Special Revenue Funds
3. Debt Service Funds
4. Capital Projects Funds
5. Enterprise Funds
6. Internal Service Funds
7. Trust and Agency Funds
8. General Fixed Assets Account Group
9. General Long-Term Debt Account Group
10. Endowment and Quasi-Endowment Funds
11. Restricted and Unrestricted Funds
12. Property Funds

D. Presentation of Financial Statements for Various Not-for-Profit and Governmental Organizations

E. Various Types of Not-for-Profit and Governmental Organizations

1. Local and State Governments
2. Educational Institutions
3. Hospitals
4. Charitable, Religious, and Other Organizations

Auditing Section

The Auditing section tests the candidates' knowledge of generally accepted auditing standards and procedures. The section includes professional responsibilities, internal control, evidence and procedures, and reporting.

In preparing for this section, candidates should study publications such as the following:

- AICPA Code of Professional Conduct
- Statements on Auditing Standards
- U.S. General Accounting Office Government Auditing Standards

Content Specification Outlines

- Statements on Standards for Accounting and Review Services
- Statements on Quality Control Standards
- Statements on Management Advisory Services
- Statements on Responsibilities in Tax Practice
- Statements on Standards for Attestation Engagements
- Statement on Standards for Accountants' Services on Prospective Financial Statements
- AICPA Audit and Accounting Guides
- Auditing textbooks

Auditing—Content Specification Outline

I. Professional Responsibilities (15 percent)

A. General Standards and Code of Professional Conduct

1. Proficiency, Independence, and Due Care
2. Code of Professional Conduct

B. Control of the Audit

1. Planning and Supervision
2. Audit Risk and Materiality
3. Analytical Procedures
4. Quality Control

C. Other Responsibilities

1. Detecting and Reporting Errors and Irregularities
2. Illegal Acts by Clients
3. Responsibilities in Review and Compilation
4. Responsibilities in Attestation Engagements
5. Responsibilities in Management Advisory Services
6. Responsibilities in Tax Practice

II. Internal Control (30 percent)

A. Definitions and Basic Concepts

B. Consideration of the Internal Control Structure

C. Cycles

1. Sales, Receivables, and Cash Receipts
2. Purchases, Payables, and Cash Disbursements
3. Inventories and Production
4. Personnel and Payroll
5. Financing and Investing

D. Other Considerations

1. Communication of Internal Control Structure Related Matters
2. Reports on Internal Control
3. Sampling
4. Flowcharting

III. Evidence and Procedures (30 percent)

A. Audit Evidence

1. Nature, Competence, and Sufficiency of Evidential Matter
2. Evidential Matter for Financial Statement Assertions
3. Analytical Procedures
4. Client Representations

Content Specification Outlines

5. Using the Work of a Specialist
6. Inquiry of a Client's Lawyer

B. Specific Audit Objectives and Procedures

1. Tests of Details of Transactions and Balances
2. Documentation

C. Other Specific Audit Topics

1. Use of the Computer in Performing the Audit
2. Use of Statistical Sampling in Performing the Audit
3. Related Party Transactions
4. Subsequent Events
5. Compliance Auditing
6. Omitted Procedures Discovered After the Report Date

D. Review and Compilation Procedures

1. Understanding of Accounting Principles and Practices of the Industry
2. Inquiry and Analytical Procedures
3. Unusual Matters
4. Other Procedures

IV. Reporting (25 percent)

A. Reporting Standards and Types of Reports

1. Unqualified
2. Explanatory Language Added to the Standard Report
3. Qualified
4. Adverse
5. Disclaimer
6. Consistency
7. Going Concern
8. Reporting Responsibilities
9. Comparative
10. Scope of Examination
11. Generally Accepted Accounting Principles
12. Disclosure
13. Review and Compilation
14. Review of Interim Financial Information
15. Special Reports
16. Negative Assurance
17. Prospective Financial Statements
18. Compliance With Laws and Regulations

B. Other Reporting Considerations

1. Subsequent Discovery of Facts Existing at the Date of the Auditor's Report
2. Dating of the Auditor's Report
3. Part of Examination Made by Other Independent Auditors
4. Letters for Underwriters
5. Filing Under Federal Securities Statutes
6. Other Information in Documents Containing Audited Financial Statements
7. Required Supplementary Information
8. Information Accompanying the Basic Financial Statements
9. Communication With Audit Committees

Business Law Section

The Business Law section tests the candidates' knowledge of the legal implications of business transactions, particularly as they relate to accounting and auditing. The section includes the CPA and the law, business organizations, contracts, debtor-creditor relationships, government regulation of business, Uniform Commercial Code, and property. The subjects on the examination normally are covered in standard textbooks on business law, auditing, taxation, and accounting. Candidates are expected to recognize the existence of legal implications and applicable basic legal principles, and they are usually asked to indicate the probable result of the application of such basic principles.

The Business Law section is chiefly conceptual in nature and is broad in scope. It is not intended to test competence to practice law or expertise in legal matters, but to determine that the candidates' knowledge is sufficient (1) to recognize relevant legal issues, (2) to recognize the legal implications of business situations, (3) to apply the underlying principles of law to accounting and auditing situations, and (4) to seek legal counsel or recommend that it be sought.

This section deals with federal and widely adopted uniform laws. Where there is no federal or appropriate uniform law on a subject, the questions are intended to test knowledge of the majority rules. Federal tax elements may be covered where appropriate in the overall context of a question.

Business Law—Content Specification Outline

- I. The CPA and the Law (10 percent)
 - A. Common Law Liability to Clients and Third Persons
 - B. Federal Statutory Liability
 - 1. Securities Acts
 - 2. Internal Revenue Code
 - C. Workpapers, Privileged Communication, and Confidentiality
- II. Business Organizations (20 percent)
 - A. Agency
 - 1. Formation and Termination
 - 2. Liabilities of Principal
 - 3. Disclosed and Undisclosed Principals
 - 4. Agent's Authority and Liability
 - B. Partnerships and Joint Ventures
 - 1. Formation and Existence
 - 2. Liabilities and Authority of Partners and Joint Owners
 - 3. Allocation of Profit or Loss
 - 4. Transfer of Interest
 - 5. Termination, Winding Up, and Dissolution
 - C. Corporations
 - 1. Formation, Purposes, and Powers
 - 2. Stockholders, Directors, and Officers
 - 3. Financial Structure, Capital, and Dividends
 - 4. Merger, Consolidation, and Dissolution
 - D. Estates and Trusts
 - 1. Formation and Purposes
 - 2. Allocation Between Principal and Income
 - 3. Fiduciary Responsibilities
 - 4. Distributions and Termination

Content Specification Outlines

III. Contracts (15 percent)

- A. Offer and Acceptance
- B. Consideration
- C. Capacity, Legality, and Public Policy
- D. Statute of Frauds
- E. Statute of Limitations
- F. Fraud, Duress, and Undue Influence
- G. Mistake and Misrepresentation
- H. Parol Evidence Rule
- I. Third Party Rights
- J. Assignments
- K. Discharge, Breach, and Remedies

IV. Debtor-Creditor Relationships (10 percent)

A. Suretyship

- 1. Liabilities and Defenses
- 2. Release of Parties
- 3. Remedies of Parties

B. Bankruptcy

- 1. Voluntary and Involuntary Bankruptcy
- 2. Effects of Bankruptcy on Debtor and Creditors
- 3. Reorganizations

V. Government Regulation of Business (10 percent)

A. Regulation of Employment

- 1. Federal Insurance Contributions Act
- 2. Federal Unemployment Tax Act
- 3. Worker's Compensation Acts

B. Federal Securities Acts

- 1. Securities Registration
- 2. Reporting Requirements
- 3. Exempt Securities and Transactions

VI. Uniform Commercial Code (25 percent)

A. Commercial Paper

- 1. Types of Negotiable Instruments
- 2. Requisites for Negotiability
- 3. Transfer and Negotiation
- 4. Holders and Holders in Due Course
- 5. Liabilities, Defenses, and Rights
- 6. Discharge

B. Documents of Title and Investment Securities

- 1. Warehouse Receipts
- 2. Bills of Lading
- 3. Issuance, Transfer, and Registration of Securities

C. Sales

- 1. Contracts Covering Goods
- 2. Warranties

Content Specification Outlines

3. Product Liability
4. Risk of Loss
5. Performance and Obligations
6. Remedies and Defenses

D. Secured Transactions

1. Attachment of Security Interests
2. Perfection of Security Interests
3. Priorities
4. Rights of Debtors, Creditors, and Third Parties

VII. Property (10 percent)

A. Real and Personal Property

1. Distinctions Between Realty and Personalty
2. Types of Ownership
3. Lessor-Lessee
4. Deeds, Recording, Title Defects, and Title Insurance

B. Mortgages

1. Characteristics
2. Recording Requirements
3. Priorities
4. Foreclosure

C. Fire and Casualty Insurance

1. Coinsurance
2. Multiple Insurance Coverage
3. Insurable Interest

Accounting Practice

Accounting Theory

Auditing

Business Law

November 1989 Uniform CPA Examination

Content Specification Outlines